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HEARINGS

BEFORE THE

SUBCOMMITTEE ON CONSUMER PROTECTION
AND FINANCE

OF THE

COMMITTEE ON
INTERSTATE AND FOREIGN COMMERCE
HOUSE OF REPRESENTATIVES

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

H.R. 11119 and H.R. 11140

BILLS TO AMEND THE SECURITIES EXCHANGE ACT OF 1934
TO AUTHORIZE APPROPRIATIONS FOR THE SECURITIES AND
EXCHANGE COMMISSION FOR FISCAL YEARS 1979-1981

MARCH 1 AND 2, 1978

Serial No. 95-110

Printed for the use of the
Committee on Interstate and Foreign Commerce



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SECURITIES AND EXCHANGE COMMISSION— AUTHORIZATION

WEDNESDAY, MARCH 1, 1978

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 9:25 a.m., pursuant to notice, in room 2218, Rayburn House Office Building, Hon. Bob Eckhardt, chairman, presiding.

Mr. ECKHARDT. This morning the subcommittee will begin 2 days of hearings on two bills prepared by the Securities and Exchange Commission, our initial witness. The first bill, H.R. 11119, would provide the Commission with 70, 80 and 91 million for the fiscal years ending September 30, 1979, 1980 and 1981, respectively. The balance of our hearings will be concerned with H.R. 11140, which would extend the May 1, 1978 implementation of section 11a of the 1934 Act to November 1, 1979. Section 11a makes it unlawful for any member of a national securities exchange to effect any transaction on such exchange for, basically, an account for which the member makes investment decisions. The section gives the Commission the authority to exempt by rule any transaction which is determined to be consistent with the purposes of the section, the protection of investors and the maintenance of fair and orderly markets.

Unfortunately, as the May 1 deadline approaches, the Commission has not been able to draft satisfactory rules. I suppose the reason may well be that there is not sufficient logic to the section for the Commission or anyone else for that matter to determine precisely what the purposes of the section are. For example, the section was designed, among other things, to prevent conflicts of interest, such as churning. The managed accounts most likely to be abused are not of course those belonging to sophisticated investors such as institutions but rather are those belonging to individuals. Nevertheless, the section exempts from its prohibitions accounts belonging to individuals.

The Commission and the brokerage community generally are asking for more time, time for the Commission to provide rules to soften some of the adverse impacts of 11a on an industry already in the throes of some profound and rapid changes.

Without objection the text of H.R. 11119 and H.R. 11140 will be placed at this point in the record.

[The text of H.R. 11119 and H.R. 11140 follow:]

95TH CONGRESS
2D SESSION

H. R. 11119

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 23, 1978

Mr. STAGGERS (for himself and Mr. DEVINE) (by request) introduced the following bill; which was referred to the Committee on Interstate and Foreign Commerce

A BILL

To amend the Securities Exchange Act of 1934 to authorize appropriations for the Securities and Exchange Commission for fiscal years 1979-1981.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That section 35 of the Securities Exchange Act of 1934 (15
4 U.S.C. 78kk) is amended—

5 (1) in the first sentence thereof, by striking out
6 “1977, and” and inserting in lieu thereof “1977,”;

7 (2) by inserting immediately before the period at
8 the end of the first sentence thereof the following:
9 “, \$70,000,000 for the fiscal year ending September 30,
10 1979, \$80,000,000 for the fiscal year ending Sep-

1 tember 30, 1980, and \$91,000,000 for the fiscal year
2 ending September 30, 1981"; and

3 (3) in the last sentence thereof, by striking out
4 "fiscal year 1978" and inserting in lieu thereof "fiscal
5 year 1981".

95TH CONGRESS
2D SESSION

H. R. 11140

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 23, 1978

Mr. ECKHARDT (for himself and Mr. BROTHILL) (by request) introduced the following bill; which was referred to the Committee on Interstate and Foreign Commerce

A BILL

To amend the Securities Exchange Act of 1934.

- 1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That section 11 (a) (3) of the Securities Exchange Act of
4 1934 (15 U.S.C. 78k (a) (3)) is amended by deleting the
5 date "May 1, 1978" in each place it appears in that section
6 and inserting in those places the date "November 1, 1979".

Mr. ECKHARDT. Our first witness this morning is Chairman Harold Williams of the Securities and Exchange Commission.

Always glad to have you.

Mr. WILLIAMS. Thank you, Mr. Chairman. With your concurrence I would propose to begin with H.R. 11119, respond to any questions and then begin my testimony on 11140.

Mr. ECKHARDT. That would be fine.

Mr. WILLIAMS. I am accompanied by George Kundahl, Deputy Executive Director of the Commission, and in the first row the division directors and office heads of the Commission.

I would like to ask that my complete statement on H.R. 11119 be included in the record.

Mr. ECKHARDT. Without objection it is so ordered.

STATEMENT OF HON. HAROLD M. WILLIAMS, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY GEORGE KUNDAHL, DEPUTY EXECUTIVE DIRECTOR, AND ANDREW M. KLEIN, DIRECTOR OF THE DIVISION OF MARKET REGULATION

Mr. WILLIAMS. Mr. Chairman and members of the subcommittee, I appreciate the opportunity to testify this morning regarding H.R. 11119, which would authorize the Commission's resource levels for the next 3 fiscal years. As you know, this legislation reflects the Commission's request for authorizations of \$70 million in fiscal 1979, \$80 million in 1980, and \$91 million in 1981.

I understand the subcommittee has been furnished with copies of the Commission's appropriation request for fiscal 1979, as well as a detailed justification for our 3-year authorization request. I would like to ask that the latter document, entitled "Budget Authorization Request for Fiscal Years 1979, 1980, 1981" be included in the record in its entirety.

During the past 10 months, I have been deeply involved in analyzing the Commission's resource requirements and shaping its priorities. The Commission has gone through a comprehensive and detailed budget planning process which required each manager to examine carefully every aspect of the program for which he or she is responsible. It involved dozens of the Commission's key officials and has enabled me to establish priorities for allocating resources in a manner which will permit the Commission to discharge its statutory responsibilities.

This has been a disciplined exercise for our staff, providing an opportunity to consider short-term resource requirements in light of long-range program objectives. We welcome the opportunity for the Commission's authorization committees to make input into this process so that together we can plan beyond the single year affected by an annual appropriation. With the added insight offered by Congressional guidance on our program priorities, we can formulate performance targets and plan ahead for projected staff increases, consistent, of course, with our ability to absorb additional personnel.

Our appropriation request for fiscal 1979 was the first product of our comprehensive planning process. Using this resource level as a

base, each program manager formulated staffing requirements for 1980 and 1981. I reviewed those levels and adjusted them in light of the Commission's responsibilities, priorities for implementation, and limitations imposed by existing resource levels. Following conversion of staffing needs into funding requirements and the addition of non-personnel costs, a 3-year authorization request was developed.

We believe that this multiyear authorization will assist the Commission in planning the most effective use of its resources. This long-range planning process is similar to those I experienced in the private sector and conforms with President Carter's guidance to all Federal agencies to begin multiyear resource planning.

Our 1979 appropriation request, now before Congress, totals \$64.8 million, which represents a 3.6 percent increase over our appropriation as revised for 1978. It will allow us an increase of 40 positions over what is currently authorized, 30 more staff years in average employment, and funding for uncontrollable cost increases. This last item accounts for over half of the dollar increase requested.

I think the subcommittee will be interested to know that the general public will shoulder the burden for less than half the Commission's requested appropriation. We estimate that during fiscal 1979 the Commission will collect in fees and deposit in the United States Treasury an estimated \$35.6 million—55 percent of our requested budget.

As I noted earlier, our proposed authorization for 1979 is based upon \$64.8 million appropriation request which I have just described. Added to that are three principal components: an estimated \$3 million to fund the Government-wide pay increase that is expected next October; \$1 million to pay for inflationary cost increases which are anticipated but could not be included in the appropriation request; and \$1.2 million for minor contingencies.

The first of these items, the October pay increase, is anticipated by the President's 1979 budget. However, since the exact amount of the pay raise has not yet been determined, it cannot be included in the Commission's appropriation request.

The inflationary cost increases which we anticipate are comprised of uncontrollable items, such as increases in utility charges and the cost of travel. Since these increases had not materialized when the budget was formulated last summer, they could not be reflected in our appropriation request. We have asked, however, that the authorization reflect the inflation which is expected to occur between budget formulation in 1977 and budget execution in 1979.

The final component is \$1.2 million for unforeseen program requirements. In this connection, I would point out that our appropriation request was originally formulated during the summer of 1977—more than 1 year before the beginning of fiscal year 1979, and more than 3 years before its conclusion. A great deal can change during that period.

By way of example, let me cite two unforeseen occurrences during the current fiscal year.

First, the General Services Administration informed us on September 14—just before the start of the fiscal year—that additional space we had long been seeking for our headquarters staff was finally

available. While the extra space will be most welcome, unbudgeted costs associated with the third headquarters location add up to \$502,000 during 1978. The full-year rental charges must be incorporated into appropriation levels for 1979 and subsequent years.

In the second instance, Congress passed legislation last July requiring all agencies to pay the cost of publishing their notices in the *Federal Register* and the *Code of Federal Regulations*. This will cost the Commission an estimated \$450,000 in 1978.

Fortunately, our 1978 authorization included enough flexibility to cover these contingencies. As a result we were able to seek a supplemental appropriation for the current fiscal year of \$1.4 million, which is now pending before Congress. It would seem to make sense to incorporate this kind of flexibility into the authorization levels now under consideration. Without the ability to seek supplemental funding, the Commission could be forced to absorb unforeseen costs within its existing budget, thus limiting resources needed to carry our program responsibilities under the Federal securities laws.

I would like to turn now to the requested authorizations for fiscal years 1980 and 1981—\$80 million and \$91 million, respectively. The nature of the activities in which the Commission will employ these additional resources is discussed in the document we have submitted for the record. I would, however, like to spend a few minutes surveying the increasing responsibilities which justify larger authorizations in the years ahead.

The foremost example of the Commission's growing responsibilities relates, of course, to creation of a national market system. In accordance with the mandate provided by our oversight committees, in January we issued an outline of those initiatives we consider necessary to accelerate implementation of a national market system. We anticipate that by 1980 the basic trading mechanisms and facilities will be operating. Consequently, rules regulating the new system will have to be developed and adopted during time frame under discussion today.

Last summer this subcommittee and the Subcommittee on Oversight and Investigations undertook a joint examination of the Commission's implementation of the Securities Acts Amendments of 1975. The report which resulted from that inquiry identified a number of areas in which the subcommittees believed that the Commission could improve its efforts to implement the legislation. In particular, the report emphasized that the Commission should devote more attention to the creation of a national clearing and settlement system and should act vigorously to implement section 13(f), which confers upon the Commission responsibility to require reports on ownership and voting power from certain large institutional managers.

Each of these initiatives is important and the subcommittees were correct in identifying them and high-lighting the need for Commission action. I think it important, however, to bear in mind that Congressional criticism and Congressional encouragement to act more vigorously in particular areas must be accompanied by the resources necessary to accomplish these tasks.

Another requirement for expanded oversight of the securities markets arises, not from new legislation, but rather from a new

development in the marketplace itself—the burgeoning growth of trading in put and call options. As a result of rapid developments in this area, the Commission has proposed a moratorium on expansion of options markets and has initiated a comprehensive review of options trading in light of the complex legal, economic, and regulatory problems which this new and specialized field has engendered. The study could result in a comprehensive new regulatory program, including new rules concerning trading practices and market structure. We would hope that any authorization level would be flexible enough to enable the Commission to administer an expanded program, if it is found to be warranted.

Another field of important activity results from the Commission's regulatory and enforcement responsibilities pursuant to the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Unfortunately, the Commission's capacity to examine effectively the activities of these financial institutions—where the collapse of a single firm could affect thousands of investors—is much less than it should be. For example, even if the Congress approves the additional staffing the President has proposed for 1979, inspections of investment advisers will be possible on an average of only once every 10.6 years. We would like to improve our capability in this important area in 1980 and 1981.

In performing its oversight role, the Commission must demand high standards of competence and integrity from those professionals who practice before it. In response to guidance from the House Oversight Subcommittee and the Senate Committee on Governmental Affairs, we have undertaken substantial new responsibilities designed to foster close and continuous communication between the Commission and professional accounting bodies. Moreover, the Commission has agreed to prepare comprehensive annual reports to Congress concerning the accounting profession's progress in response to the issues raised during the House and Senate hearings. Further, the Commission has initiated measures to encourage the establishment of audit committees for publicly-held companies, to promote the independence of accountants who practice before the Commission, and to establish priorities with respect to the resolution of issues concerning the adoption and application of accounting principles.

Recent developments have placed unprecedented demands on the Commission's litigation and enforcement staff and have strained its ability to continue to discharge its statutory responsibilities with current funding. With increasing frequency, individuals and corporations are contesting charges brought by the Commission in both administrative and district court enforcement proceedings. Further, appeals from the ensuing administrative orders or judicial decisions have multiplied in recent years, and the issues involved have become more complex. Accordingly, it is essential that the Commission increase its own litigation capabilities in order to keep pace. At the same time, the emerging case law tends to restrict the ability of private plaintiffs to seek redress in civil actions under the Federal securities laws, partially eliminating a valuable supplement to the Commission's enforcement program.

Similarly, in response to public revelations of widespread abuses, the Commission has conducted an extensive and continuing program to insure adequate disclosure to investors of instances in which public companies have engaged in questionable or illegal payments—especially bribery of foreign government officials. The recently-enacted Foreign Corrupt Practices Act of 1977 emanated in large measure from abuses which the Commission uncovered. As this subcommittee knows, that Act obligates us to oversee new standards of corporate behavior and accounting controls. It also increases our responsibilities in connection with the reporting of beneficial ownership of securities. Nevertheless, our appropriation request for 1979 does not include any additional resources with which to carry out these expanded responsibilities.

Finally, the Commission has embarked upon a series of hearings pertaining to full disclosure. The Commission recently concluded public hearings in four cities concerning ways in which corporate accountability could be strengthened and shareholder participation in corporate governance enhanced. While the Division of Corporation Finance is now in the process of summarizing the voluminous file compiled in these proceedings, it is already clear that there are widely divergent and strongly held convictions concerning the accountability of American corporations. Later this month the Commission will convene hearings to assure the development of uniform accounting practices for producers of crude oil and natural gas. And in April, the Commission will hold public hearings to determine the impact of its rules and regulations on small businesses, particularly with respect to their ability to raise capital. The hearings will attempt to determine whether existing capital-raising vehicle present an unnecessary deterrent to capital growth. The pending authorization levels must be elastic enough to permit the Commission to follow through on the conclusions drawn from these hearings.

Mr. Chairman, my statement today has attempted to provide the subcommittee with an overview of what we perceive to be the Commission's responsibilities during the next 3 years and the resources we feel will be required to meet these challenges. The importance of our securities markets to the economic health of this nation is, I know, well understood by this subcommittee, as is the extent of the changes which those markets are now undergoing and the Commission's role in this evolution.

I appreciate this opportunity to meet with you and discuss the rationale and importance of our multiyear authorization request. I will be happy to try to answer any questions you may have.

[The following information was received for the record:]

JUSTIFICATION FOR SEC BUDGET AUTHORIZATION, 1979-1981

The Securities and Exchange Commission is seeking legislation which would provide budget authorization of \$70 million in fiscal year 1979, \$80 million in 1980, and \$91 million in 1981. These resource projections have been built on the foundation provided by the President's budget for 1979, which includes a request of \$64.8 million for the Commission. This document is intended to explain the importance of a multi-year authorization and to provide justification for the authorization levels requested.

The discussion is divided into four parts. The first deals with the concept of budget authorization and its application to independent regulatory agencies. Next is a brief discussion of long-range planning and the budget formulation process. This is followed by an overview of recent developments in the securities industry vis a vis the capacity of the Commission to respond. The last section addresses the specific authorization levels proposed in fiscal years 1979, 1980, and 1981.

The congressional committees responsible for overseeing the activities of the SEC — the Committee on Interstate and Foreign Commerce in the House and the Committee on Banking, Housing and Urban Affairs in the Senate — can be assured that after enactment of authorization legislation, they will be informed of any significant changes in the Commission's resource requirements, even though an

amendment to the authorization bill may not be required. The Commission is striving to provide an open and complete explanation of its program activities and resource requirements. The preparation of this authorization document -- unique among the regulatory agencies -- is one indication of the Commission's interest in improving the justification materials which support its resource requests to the Congress.

I. Authorizing legislation as applied to the SEC and other regulatory agencies

An "authorization" or authorizing legislation is defined by the General Accounting Office as:

"Basic substantive legislation enacted by Congress which sets up or continues the legal operation of a Federal program or agency either indefinitely or for a specific period of time or sanctions a particular type of obligation or expenditure within a program. ... It may limit the amount of budget authority to be provided subsequently or may authorize the appropriation of "such sums as may be necessary."

There are ten independent Federal regulatory agencies of approximately comparable size and responsibility. Six are presently funded on the basis of an indefinite or standing budget authorization -- the Civil Aeronautics Board, Federal Communications Commission, Federal Maritime Commission, Federal Power Commission*, Federal Trade Commission

* Creation of the Department of Energy has incorporated the Federal Power Commission into the new Federal Energy Regulatory Commission. The old Federal Power Commission has operated under standing or indefinite budget authority. However, the statute which establishes the new department requires specific annual authorizations, beginning in fiscal year 1979 for all components.

and Interstate Commerce Commission. Of the four remaining agencies with definite or fixed budget authorizations, only the Securities and Exchange Commission and the Nuclear Regulatory Commission are authorized appropriations on a single-year basis. The other two agencies, the Commodity Futures Trading Commission and the Consumer Product Safety Commission, have been granted budget authority for a three-year period.

Authorizations and Appropriations of the
Securities and Exchange Commission, 1976-1981
(\$000)

<u>Fiscal Year</u>	<u>Enacted</u>			<u>Requested</u>			
	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
Authorization	51,000	56,500	63,750	No change	70,000	80,000	91,000
Appropriation	49,291	56,270	58,100	62,500	64,800	Not yet proposed	

Prior to 1975, appropriations for the Securities and Exchange Commission were based on the open-ended budget authorization contained in the Securities Exchange Act of 1934. The specific sum was determined by the size of the Commission's annual appropriation(s). However, during Congressional deliberations over the Securities Acts Amendments of 1975, the House inserted language to authorize a specific level of appropriations for the SEC in fiscal years 1976, 1977, and 1978.

The House Committee on Interstate and Foreign Commerce explained the reasons for its proposed authorization levels in a report to the full House.

"The workload of the Securities and Exchange Commission has increased tremendously over the years.... For example, in 1941 only 260 million shares of stock were traded on the Nation's securities exchanges; by 1971 trading had grown to 4.86 billion shares. This represented an increase in dollar volume from \$5.9 billion in 1941 to \$152.8 billion in 1971.

In 1941 there were 2,350 companies reporting under the Securities Exchange Act; by 1971 that amount had grown to 9,572. The number of reports filed under the Securities Exchange Act in 1941 totaled 4,940; by 1971 filed reports had increased to 32,472. Notwithstanding these tremendous increases, the size of the Commission staff actually declined in numbers from 1941 to 1971, going from 1,711 to 1,410.

In 1972, the Commission established an Advisory Committee on Enforcement Policy and Practices. The Advisory Committee concluded that the Commission should establish a goal of doubling the size of its total staff over the next five years. That goal appears reasonable to your Committee, and the authorizations limits in this section, while expressed in terms of maximum limitations, are set at levels sufficient to permit attainment of that objective."

The Senate version of the Amendments did not include a provision concerning SEC authorizations. However, the conference committee decided to establish authorization levels for the Commission by specifying amounts in fiscal years 1976 and 1977 and requiring definite authorizations in subsequent years. This compromise was subsequently

enacted as Section 24 of the Securities Acts Amendments of 1975 (P.L. 94-29).

"There are hereby authorized to be appropriated to carry out the functions, powers and duties of the Commission not to exceed \$51,000,000 for the fiscal year ending June 30, 1976 and not to exceed \$55,000,000 for the fiscal year ending September 30, 1977. For fiscal years succeeding the 1977 fiscal year, there may be appropriated such sums as the Congress may hereafter authorize by law."

The shortcomings associated with a fixed authorization level soon became evident. In January, 1977, the Commission asked the Congress to increase its 1977 authorization to \$58 million. The revised amount was necessary to accommodate supplemental appropriations required to fund the mandatory wage increase granted Federal employees in October, 1976, and to allow the appropriation of funds to engage in a multi-year modernization of the Commission's automatic data processing systems. After extended consultation with Congressional staff, the Commission reduced its request to \$56.5 million, which the Congress subsequently enacted into law (P.L. 95-20).

In February, 1977, the SEC proposed that Congress enact a three-year authorization for 1978-1980 in the amounts of \$64, \$70, and \$75 million. The request did not provide for any personnel growth beyond the level contained in the Commission's 1978 budget. In light of the leadership change underway at the Commission, the House Commerce Committee decided to recommend only a one-year authorization, in order to allow the new chairman to formulate his own program for 1979 and 1980 and present

it to Congress at a later date. The Committee reported a bill authorizing \$67 million to be appropriated in 1978. The Committee report gave the following explanation for the recommended increase in the requested 1978 authorization level.

"The Committee feels that an independent regulatory agency has a much larger duty than merely to acknowledge the existence of conditions which greatly impair its ability to adequately serve the public. A manpower shortage and overcrowded conditions do exist at the Commission. They are becoming worse and they will not resolve themselves, particularly within the confines of rigid and unrealistic budget constraints.

Accordingly, the committee is authorizing an additional \$3 million or an increase of 4.6 percent over the original Commission request for fiscal 1978. It is the intention of the committee that the Commission, under its new chairman, will request appropriations of such sums as are necessary to acquire additional space to alleviate the existing overcrowded conditions and to provide for increased personnel. The committee perceives that those areas which are particularly in need of additional staff in light of the present and anticipated workload are the Division of Enforcement, the Office of General Counsel and the regional offices.

The Senate passed a bill authorizing \$58,290,000 for 1978. The conference committee eventually agreed on a figure of \$63,750,000 which was then enacted into law (P.L. 95-211).

II. The importance of long-range planning in the budget formulation process

Long-range planning is an important component of the budget formulation process. The Congress has acknowledged the importance of looking beyond the immediate budget year to take into account the

longer-term effects of pending budget decisions. The Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344) requires the submission of requests for new budget authority in the year before the beginning of the fiscal year affected.

Sec. 607. Notwithstanding any other provision of law, any request for the enactment of legislation authorizing the enactment of new budget authority to continue a program or activity for a fiscal year (beginning with the fiscal year commencing October 1, 1976) shall be submitted to the Congress not later than May 15 of the year preceding the year in which such fiscal year begins. 1/

Long-range planning is also an important part of President Carter's management of resources. Establishment of long-range objectives was an essential first step in the implementation of zero-base budgeting. On January 12, 1978, President Carter sent a memorandum to the heads of executive departments and agencies asking them to incorporate multi-year budget planning into their budget formulation processes. The President noted that "it has become very difficult for either the Congress or the President to plan budgets effectively just one year in advance." Subsequently, on January 16, 1978, the Office of Management and Budget issued Bulletin No. 78-7 amplifying the President's guidance. The President's 1979 budget summarizes the reasons for this emphasis on multi-year budget planning:

1/ To comply with this requirement, the Commission must present its 1980 request prior to May 15, 1978.

"The result will be more effective use of the taxpayers' dollars and better control of the Federal budget. Further, the private sector, which makes wide use of multiyear budget planning, and the State and local sector will have a clearer view of Federal Government programs and intentions. Finally, the Congress will have a broader context within which to develop and project its concurrent resolutions on the budget and develop authorization and appropriation measures."

Within the SEC, the budget planning process for fiscal year 1979 began in earnest during the summer of 1977, when top management began formulating goals and objectives for the Commission's eight major programs in the course of implementing zero-base budgeting. The program goals, long-range objectives, and 1979 objectives cited in the Congressional budget justification are the products of that intensive formulation process. Similarly, the program levels requested for 1979 also emanated from last summer's budget preparation process, as modified by OMB in its annual fall budget review.

The 1980 and 1981 program levels were developed in a planning exercise which followed development of the 1979 budget, partially in conjunction with the preparation of this authorization request. The division directors with coordinating responsibility for the Commission's eight major programs were asked to develop staffing projections for 1980-1981, taking into account the long-range objectives already formulated, headquarters requirements, and input from the Commission's nine regional offices. These projections were reviewed by the Chairman, who considered them in light of long-term priorities for the Commission. After adjusting the personnel

estimates to reflect those priorities, the Office of the Comptroller converted the proposed position levels into personnel costs and factored in related non-personnel expenses.

Enactment of a three-year authorization will bolster the Commission's ability to engage in meaningful multi-year planning. It will provide an indication of the activity level at which the Congress intends for the Commission to operate. This will facilitate responsiveness to requests from OMB for multi-year budget data, collected as part of an overall compilation of revenue and outlay estimates for the Federal Government. A fixed authorization level for 1979, 1980 and 1981 will also assist the Commission in reviewing priorities and sizing budget requests for these years to coincide with Congressional expectations. The forthcoming hearings before the House and Senate oversight committees on the Commission's authorization and increased dialogue with staff members will serve to identify those programs where additional emphasis is required, as well as those activities which are considered to be already funded to provide an acceptable level of service.

III. Recent changes in the regulatory environment for securities

A new era in the regulation and enforcement of federal securities laws dawned in 1975, when Congress enacted the Securities Acts Amendments. This legislation not only strengthened the basic statutory authorities under which the Commission operated for over 35 years but it also

gave the SEC responsibilities in areas previously untouched by the Federal Government. The 1975 Amendments truly represent the most important securities legislation since 1940.

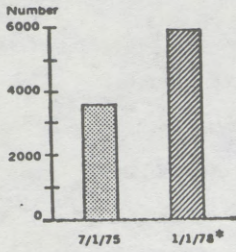
Specifically, this legislation expanded the Commission's regulation and oversight of the securities industry by:

(a) Directing the Commission to facilitate the establishment of a national market system, linking all markets for qualified securities by modern data processing and communications facilities. To achieve that objective, the Commission is directed to help create a national market system and regulate the activities of its participants. The National Market Advisory Board was created by the Amendments to aid the Commission in this task and to study the need for a new self-regulatory body to administer the national market system. In addition, the Amendments direct the Commission to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions. The Amendments also impose registration and other regulatory requirements upon securities information processors and transfer agents. Finally, the Commission is directed to eliminate the physical transfer of stock certificates between parties.

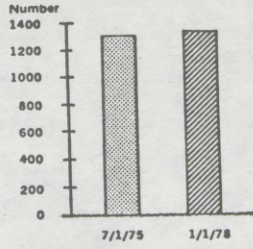
(b) Strengthening the Commission's regulatory authority over self-regulatory bodies (exchanges, associations, etc.) and their members. The Act requires Commission approval of rules proposed by self-regulatory organizations and grants to the Commission the power to review denials of access or membership as well as

Figure I

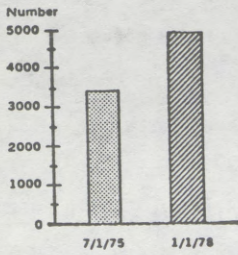
CHANGES IN SEC REGISTRANT BASE



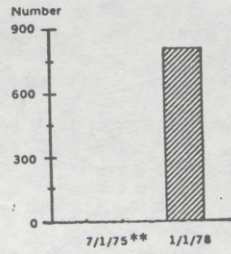
BROKER-DEALERS (+65%)



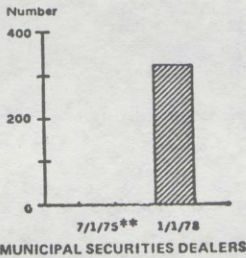
INVESTMENT COMPANIES (+0.3%)



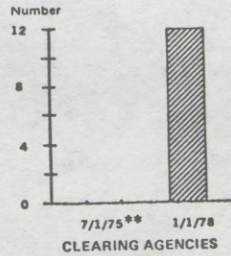
INVESTMENT ADVISERS (+44%)



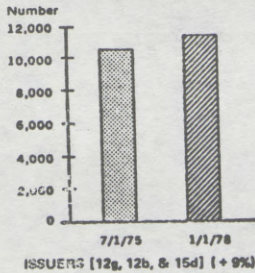
TRANSFER AGENTS



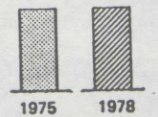
MUNICIPAL SECURITIES DEALERS



CLEARING AGENCIES



ISSUERS (12b, 12b, & 15d) (+9%)



*Includes approximately 2,300 "floor members" who have registered pursuant to the 1975 Acts Amendments.

**Not required to register prior to 1975 Acts Amendments.

disciplinary actions. Furthermore, brokers and dealers, as well as other entities, are obliged to report information on missing, lost and stolen securities, while registrant officials and other personnel are, for the first time, subjected to fingerprinting requirements.

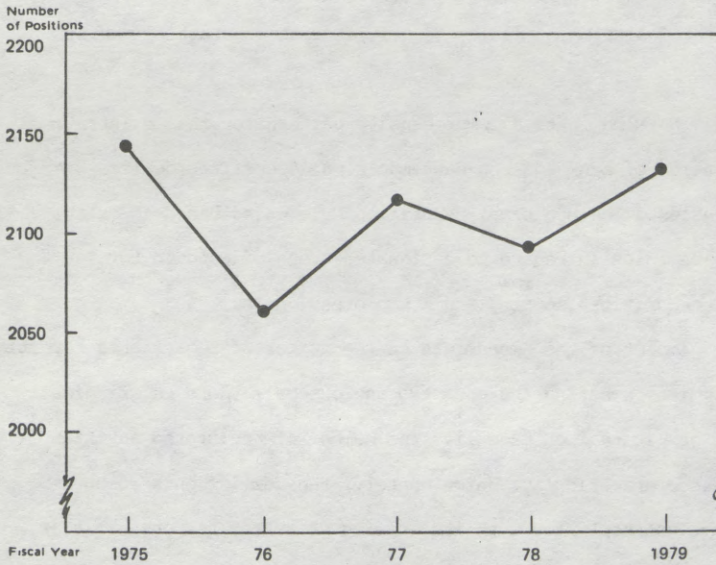
(c) Requiring institutional investment managers to file periodic reports, unless otherwise exempted, disclosing particular facts with respect to their holdings, and to make public reports on the management of accounts consisting of equity securities with substantial market value.

(d) Setting forth a comprehensive pattern for the registration and regulation of bank and non-bank municipal securities dealers by the Commission. The Municipal Securities Rulemaking Board is established to prescribe rules in regard to designated areas of concern for the municipal securities industry and its professionals.

The impact of the Amendments on the number of registrants reporting to the Commission during the past two and one-half years is graphically displayed on Figure I on page 11. The number of registered entities has increased dramatically. Unfortunately, the Commission's resource levels have not kept pace with its growing statutory responsibilities. Even if the Congress appropriates the full amounts requested for the SEC in the President's 1979 budget, the Commission will nevertheless have fewer authorized personnel than in 1975, when the Securities Acts Amendments were signed into law. Figure II on page 13 portrays the unevenness in personnel levels at the SEC over a five-year period, 1975-1979. After considering this peculiar pattern of resource allocation, it should be evident why the Commission seeks to better understand the program level at which it may be authorized to operate in the years ahead.

Figure II

**AUTHORIZED POSITIONS FOR THE SECURITIES & EXCHANGE COMMISSION
SINCE ENACTMENT OF THE SECURITIES ACTS AMENDMENTS OF 1975**



IV. An explanation of the authorization levels proposed by the SEC

The Commission's three-year authorization request builds on the President's 1979 budget, which provides \$64.8 million for the SEC. A detailed justification for that request was transmitted to the Congress on January 24, 1978.

Proposed 1979 Authorization

Pending 1979 Appropriation	\$64,800,000
(1) October, 1978, Federal pay raise	3,000,000
(2) 1978 inflationary increases	1,000,000
(3) Allowance for contingencies	<u>1,200,000</u>
1979 Authorization Request	\$70,000,000

The SEC is requesting an authorization level of \$70 million for 1979, compared with a pending appropriation of \$64.8 million. The difference of \$5.2 million consists of three elements -- the October, 1978, pay raise, anticipated inflation, and unforeseen requirements. These additions can not significantly change the program levels approved by the President and included in his 1979 budget. To the contrary, if these factors are ignored, the Commission may well be required to cut into its established programs to obtain the resources necessary to satisfy uncontrollable cost increases.

(1) The President's 1979 budget includes an allowance to cover a statutory pay increase for Federal civilian agency employees, effective in October, 1978, and estimated to be no more than 6 per cent. However, the funding for this increase is not now allocated to the various executive agencies, but rather excluded from the Commission's 1979 request and earmarked elsewhere in the President's budget. The Commission estimates that its share of this amount is approximately \$3 million, including the associated cost increases in personnel benefits.

(2) OMB requires agencies to compute "other than personnel" expenses on a current cost basis. Anticipating inflationary cost increases is not permitted. Therefore the Commission's 1979 budget has been constructed using actual 1977 prices. It is reasonable to assume that inflation will take place before the 1979 budget is implemented. Even though the Commission makes every effort to absorb these costs to the greatest degree possible, provision should be made for an inflationary increase in the authorization now under consideration. The Commission's authorization request includes an increment of \$1 million for this purpose or approximately 7 per cent of its non-personnel costs, calculated at 1977 rates.

(3) An additional \$1.2 million is included for unforeseen program needs and contingencies. The Commission's initial 1979 budget request to OMB, on which the President's budget is based, was formulated in the summer of 1977, more than a year before the beginning of fiscal 1979 and more than two years before its conclusion.

In an area as active as the securities industry, a great deal can change during that time span. A \$1.2 million increment is a modest amount which will provide some flexibility in the event that the President approves a small supplemental request to enable the Commission to address a development within the Commission's responsibility which is not now evident or to meet an unforeseen expense of relatively minor proportions. For example, the recently-enacted requirement that all Federal agencies pay the cost of publishing notices in the Federal Register and the Code of Federal Regulations has caused the Commission to request the related funding as part of a 1978 supplemental appropriations package now before the two Appropriation Committees. As a matter of policy, the Commission would confer with the oversight committees when seeking appropriation for these contingencies. In the event of a major change in Commission direction, requiring a substantial supplement to the 1979 resource level now under consideration, the SEC would return to the oversight committees to seek their concurrence for an amendment to the 1979 authorization.

Proposed 1980 and 1981 Authorizations

The SEC is requesting authorization levels of \$80 million in 1980 and \$91 million in 1981. Factored into these estimates are salary rate increases in both years and the anticipated impact of inflation. The estimate for "other expenses" in 1980 and 1981 allows for the increased cost of equipment, travel, printing and supplies. This projection also includes a cost factor for supporting the higher projected staffing levels anticipated in these years.

Two extraordinary accounts were computed separately, as they involve non-recurring increases which would otherwise skew the cost factor per employee. The first is the cost of renting office space. The Public Buildings Service of the General Services Administration now reappraises space rentals on a three-year cycle and adjusts user rates accordingly. Increases of approximately \$300,000 are expected in both 1980 and 1981. The second is the ADP improvement project. ADP systems costs will increase during the time frame under consideration as the Commission pays the rental charges for computer components which are added to implement the five-year ADP plan.

	Estimated Requirements (\$000)		
	<u>1979</u>	<u>1980</u>	<u>1981</u>
Salary and cost of related benefits	53,321	62,468	71,612
All other expenses	10,773	11,670	13,021
Extraordinary expenses:			
A. Rental of space	3,796	4,096	4,396
B. ADP improvement	910	1,766	1,971
Unforeseen contingencies	<u>1,200</u>	<u>---</u>	<u>---</u>
TOTAL AUTHORIZATION REQUEST	<u>70,000</u>	<u>80,000</u>	<u>91,000</u>
Projected Number of Authorized Positions	2,132	2,340	2,485

Not factored into the resource estimates, but of critical importance to the Commission, is the need to consolidate its headquarters offices at one location. The SEC is not a large agency, and the activities conducted in Washington are closely intertwined. The Commission's ability to

coordinate its rule-making and policy formulation activities, as well as carry on basic management support functions, is severely hampered by the present space configuration. Hopefully, over the three-year period addressed in the authorization request, the Commission will succeed in convincing GSA to enable the SEC to consolidate its three separate headquarters locations and operate once again under one roof.

The projected increase in staffing would have a significant and essential effect upon the Commission's ability to move toward the accomplishment of its long-range program objectives, as stated in materials submitted to the Congress in justification of its 1979 appropriation request. Naturally, the urgency to expand some programs is greater than the need to increase others. There follows a brief discussion of the kinds of growth which might take place, presented in order of priority.

Regulation of securities markets - The Commission is taking a leadership role in the formation of a national market system. The Commission's program is being outlined in 1978, and developmental steps will occur in 1978 and 1979. By 1980, basic trading mechanisms and facilities will be operating, and new rules regulating the use of the system will have to be developed and adopted. Moreover, new oversight initiatives for governing the new system and exercising surveillance over trading must be formulated and implemented by that time. A national market system will consist of an extremely complex system of interrelated trading mechanisms. The increased sophistication in operation will require more finely-tuned rule-making and oversight on

the part of the SEC. At the same time, increased use of multiple instruments — equities, options, municipal securities, GNMA's, and tax shelters, to name only the most common forms traded today — intensify the complexity of the market oversight responsibility.

Personnel projections for 1980 and 1981 assume that the conclusions and recommendations emanating from the special study of the options markets, now underway, will require additional staffing to implement. It is anticipated that the study report will result in a comprehensive new regulatory program for options trading, including new Commission rules regulating trading practices and options market structure, increased emphasis on Commission oversight of self-regulation by options exchanges, and creation of a staff unit to administer the Commission's expanded options regulatory program.

Prevention and suppression of fraud - In order to continue to discharge its enforcement responsibilities in the years ahead at the current level of effectiveness, the Commission must address fraudulent devices and schemes of growing complexity. Because of the large sums of money involved and the very real opportunities for illicit gain, securities frauds often entail creative, novel and rapidly changing schemes. Indeed, the complexity of securities frauds is, in part, an outgrowth of the Commission's success in eradicating many of the improper practices prevalent in earlier years. As

Commission oversight of the marketplace has become effective and widely recognized, the unscrupulous elements have turned to new, more sophisticated and intricate devices in a continuing effort to avoid detection. Accordingly, Commission investigations have become progressively more complicated and time consuming. In addition, there has been a growing inclination throughout our society to litigate points in dispute, and this propensity to mount judicial challenges to government action of all kinds has had its effects on the Commission's fraud suppression program. Commission enforcement proceedings develop into protracted and complex litigation with increasing frequency. At the same time, a highly skilled and specialized private securities bar has evolved. Defendants in Commission litigation generally have the financial capability to retain first-rate counsel when they elect to contest Commission charges. Trial preparation and conduct accordingly impose very substantial demands on the Commission's enforcement staff. Likewise, the private bar often relies on extensive clerical and paralegal support services to assist it in complex securities litigation; the Commission must, therefore, likewise enhance the support on which its legal staff may draw. The tendency for defendants to resort to litigation to test the sufficiency of Commission charges is, of course, not in itself undesirable. It does, however, mean that the Commission must increase its legal staff simply to insure that the investing public enjoys the same degree of protection which the Commission was previously able to provide with fewer resources.

In addition to this overall trend toward more complex and time-consuming investigations and enforcement proceedings, a number of developments in the marketplace will place new demands on the Commission's investigative, surveillance, and enforcement capabilities. Some of these are listed below.

— The anticipated complexity of the evolving national market system, described earlier, will make the job of market surveillance a more demanding one. In particular, greater industry reliance on automatic data processing and electronic data transmission create a potential for new dimensions in fraudulent or manipulative practices incident to securities trading. Accordingly, the Commission's enforcement capabilities will have to expand to encompass more sophisticated techniques to ferret out and prevent fraud in the national market system environment. That capability may well have to include costly computerized surveillance procedures.

— The burgeoning growth of trading in put and call options demands that the Commission enhance its regulatory capabilities in order to keep pace, and the Commission recently commenced a comprehensive review of options trading in light of the complex legal, economic, and regulatory problems which this new and specialized field has engendered. Further, the possibilities of fraud in connection with the coordinated trading of both an option and the underlying security require significantly increased Commission activity in this area.

— Another growing problem involves Government National Mortgage Association (GNMA) forward transactions — the sale of contracts to be issued at a future date. A number of investigations are presently under way concerning fraudulent sales of these securities, and in one instance a special task force has been formed to examine the financial operations of a major university jeopardized by involvement in GNMA trading. At this point, it is difficult to determine the range of abuses or the extent to which the Commission may become involved over the next three years; the area is, however, one which will demand attention.

— The new requirement, enacted as part of the Securities Acts Amendments of 1975, that municipal securities dealers register with the Commission, has led to discovery of an unusual incidence of violations which, in turn, has generated additional enforcement workload. Municipal bond investments are of increasing interest as inflationary pressures raise incomes and new, generally less-sophisticated, investors are elevated into higher tax brackets. Accordingly, the role of the Commission's enforcement efforts in this market has become more significant.

— The growth in tax shelters during the past few years has also spawned special enforcement problems. In some instances, the Commission has encountered abuses including high-pressure sales techniques, misleading sales literature, and the diversion of funds to purposes different from those represented to investors. The opportunity for self-dealing and other misconduct in this field requires expansion

in the Commission's enforcement program.

— The internationalization of the securities markets has generated increasing numbers of cases involving transactions which are, in part, foreign. The problems in investigating events and entities outside the United States are obviously greater than in domestic cases. The Commission believes, however, that this area requires attention since a decrease in investor confidence, particularly among foreign nationals, could have a serious adverse impact on both the ability of American capital markets to attract funds from overseas and on investments by United States citizens in foreign markets.

— The Commission must devote additional manpower to monitor compliance with those provisions of the federal securities laws governing corporate take-overs, tender offers and proxy contests. This problem is exacerbated by low market prices in recent years which enhance the attractiveness of take-overs and result in greater incidence of abuse. Similarly, significant numbers of public companies have undertaken to repurchase their shares from the public and thus to return to private status. This later phenomenon has led to a number of Commission enforcement actions and, more significantly for future fiscal years, the Commission has proposed comprehensive rules to govern "going private" transactions. The Commission anticipates that the enforcement of those rules, if adopted, will place a significant new burden on the enforcement staff.

— The role of the Office of Consumer Affairs is growing in response to an increasing volume of consumer complaints and wider recognition of the Office's existence. The Office will need adequate resources to develop a close working relationship with self-regulatory organizations, increase its investor education initiatives and respond to the growing volume of investor correspondence. The Commission believes it important that the Office of Consumer Affairs have appropriate funding because of the Office's role in fostering investor confidence in both the Commission and the securities markets and because matters brought to its attention by individual investors often serve to identify problems which demand regulatory or enforcement action.

Investment management regulation - The long-range plan for this program is to reduce the inspection cycle for investment companies and investment advisers to 3 and 4 years, respectively, by 1981. There are several reasons for this objective.

The present inspection program is clearly inadequate. The Commission is currently able to inspect investment advisers on the average of only once every 10.4 years and investment companies only once every 4.4 years. This situation is further exacerbated by the significant growth in the number of investment advisers registering with the SEC, as reflected in Figure I on page 11. With the resources which the Commission can presently afford to devote to this activity, there can be no assurance that investors are receiving full and fair

disclosure from investment advisers and investment companies. The inspection cycle represents the average time between inspections. Recognizing that a significant number of all inspections are "for cause" (and without regard as to when last inspected), a four year cycle, for example, actually means that many companies might not be inspected for six or more years. More frequent inspections would permit a program of "start-up inspections" (within the first year of the inspected entity's operation). Such inspections are necessary to detect and eliminate inadvertent violations by new registrants. Increased frequency of inspections would have a marked prophylactic effect on the industry. Where violations do occur, the time interval before detection would be reduced, thus minimizing damages to investors by effecting, where appropriate, a return of monies to investors and/or permitting litigation before the statute of limitations expires.

Full Disclosure - The projected increase in staffing in 1980 over 1979 levels and the further increase in 1981 reflect in part the additional staff necessary to achieve progress toward the long-range objective of giving full review to all annual and other periodic reports filed pursuant to requirements of the Securities Exchange Act of 1934. Based on workload estimates for those years, the personnel increase in 1981 would allow for the full review of only 50% of the estimated annual reports filed on Form 10-K. Additional staff are expected to be needed to process large

increases in requests filed under the Freedom of Information Act and Privacy Act. Commission workload related to these acts increased by 35 per cent and 500 per cent, respectively, in 1977 over 1976.

Over the next three years, the Commission will begin shouldering the added responsibilities conferred by the Foreign Corrupt Practices Act of 1977. The SEC is charged with ensuring that reporting companies make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuers. The Securities Exchange Act of 1934 is further amended to make it unlawful for any reporting company to make payments to foreign officials in order to influence an act or decision which would assist in obtaining business. No additional resources are included in the President's 1979 budget to enable the Commission to carry out these responsibilities.

Legislation now under consideration in the Congress could further change the nature of the Commission's full disclosure workload. Several pending bills would substantially increase the dollar ceiling under Section 3(b) of the Securities Act. While this would ease the reporting burden on small issuers, it may well generate additional filings and would also increase the importance of a thorough review of these filings by SEC staff. While it is difficult to estimate precisely the volume of new filings which would be generated by the pending legislation, the staffing levels proposed for the full disclosure program in 1980 and 1981 give minimal recognition to this potential requirement.

Executive and staff - Personnel projections for 1980 and 1981 in this area include staffing increases comparable to those planned for the Commission as a whole. Staffing of the support offices in past years has not kept pace with increases in substantive responsibilities. As a result, the management analysis function is nearly dormant, contracting capability is weak, the data processing facility is outmoded and unable to support the operating divisions and personnel programs are oriented more towards processing transactions than towards effective personnel management. The Commission must re-establish a capability to perform management reviews, improve performance evaluation and management development programs and provide resources with which to initiate organization and manpower planning. As a result, the effectiveness of the operating divisions and the agency as a whole will be improved.

In addition, oversight of the accounting profession is also expected to consume a greater proportion of the Commission's staff resources as public expectations rise regarding corporate governance and full and fair disclosure by accounting firms retained to audit corporate financial affairs.

Corporate reorganizations - Present staffing levels are inadequate to permit the Commission to participate as a party in all proceedings where the rights of public investors are involved. There has not been one case since 1974 in which the Commission has not had to request at

least one extension in order to file an advisory report with the court. Provision is made in 1980 to improve the Commission's ability to perform its unique role under the Bankruptcy Act.

Economic and policy research - A modest staff increase is programmed in 1980 and 1981 to permit the Directorate of Economic and Policy Research to improve the economic and statistical analysis which contributes to the Commission's rulemaking function and its ability to evaluate the cost-effectiveness of Commission activity.

Public utilities holding company regulation - Uncertainties in obtaining supplies of energy have caused many holding companies to embark on major and expensive new commitments to acquire better control over their own fuel supplies, and these commitments require substantial additional capital. This trend has prompted the Commission to initiate a program of auditing and monitoring service companies and fuel company subsidiaries, but the current staffing levels are inadequate to discharge this responsibility, as required by Sections 13 and 15(f) of the Public Utility Holding Company Act of 1935.

Mr. ECKHARDT. Mr. Broyhill.

Mr. BROYHILL. Thank you, Mr. Chairman.

With respect to your authorization request, what is your projection for increased staff for implementing the national market system? I realize you are going to have to have additional personnel develop policy, formulate rules and so forth. Do you have any estimate relative to that?

Mr. WILLIAMS. Our estimate, in terms of the national market system itself and what I might characterize as its direct implications, calls for some 33 more people in 1980 and 15 additional people in 1981.

Mr. BROYHILL. That is additional?

Mr. WILLIAMS. That is right.

Mr. BROYHILL. Do you know how many you have assigned to it now?

Mr. WILLIAMS. Regulation of securities markets, which is the national market system and all the other activities that revolve around it, total 308 people, including those that we expect or hope will be appropriated in 1979.

Mr. BROYHILL. You made reference to the need for increasing the litigation and enforcement staff. What is the level of that staff now? What do you project for the future?

Mr. KUNDAHL. In 1978 there are approximately 690 people engaged in suppression of fraud activity. We are asking the Congress for 14 additional positions in 1979 to bring this program up to approximately 604 positions.

These figures include the bulk of our people in the regional offices as well as our home office staff working in this area. At headquarters we will have 207 people within our Division of Enforcement. The balance are either in consumer affairs or records section or are out in the field. We are looking there for an increase of some 60 a year in 1980 and 1981.

Mr. BROYHILL. On page 10 I think it is you state that you need additional resources to implement the Foreign Corrupt Practices Act that we passed last year. Could you give us a little projection on that? What your needs will be?

Mr. WILLIAMS. My recollection is we did submit an estimate at one time. I don't recall what it was. I don't have it with me. We will have to get that for you, sir.

Mr. BROYHILL. With respect to section 11a, at your request Mr. Eckhardt and I introduced this legislation for the purpose of having people express themselves on this issue. If for one reason or another, this legislation is not enacted either by May 1 or not enacted at all, is it your intention to force the May 1 deadline? What timetable would that be and so forth?

Mr. ECKHARDT. Mr. Broyhill, don't you think it might be well to have the Chairman's statement on 11f?

Mr. BROYHILL. All right.

Mr. WILLIAMS. I would rather answer that in the context of my statement on section 11(a) if I may.

Mr. BROYHILL. I am not sure I am going to be here.

That is all the questions I have.

Mr. ECKHARDT. Last year as a result of SEC's authorization hearings before this subcommittee and the full committee report, House action was voted to increase the authorization for fiscal 1978 by 3 million. We thought as a result of budgetary constraints the Commission had been handicapped in its ability to discharge its services at that time. I would like to explore what has been done in these areas. I think Mr. Broyhill already brought out some of the questions concerning the enforcement division.

On page 12 of the authorization request indicates that with the full amount requested for the 1979 budget the Commission will nonetheless have fewer authorized personnel than in 1975.

Also on the chart on page 13 I notice you said you had increased certain of the enforcement division regional office forces.

What is cut back?

Mr. WILLIAMS. I don't have 1975 before me. I will need to submit that for the record.

[The following information was received for the record:]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., May 24, 1978.

HON. BOB ECKHARDT,
Chairman, Subcommittee on Consumer Protection and Finance Committee on
Interstate and Foreign Commerce, U.S. House of Representatives, Wash-
ington, D.C.

DEAR CONGRESSMAN ECKHARDT: In the course of the Subcommittee's hearings of March 1 dealing with H.R. 11119 and H.R. 11140, I was asked to furnish certain information later in written form. This letter responds to that request.

First, I was asked to supply a projection the Commission made as to the additional resources we would require to implement the Foreign Corrupt Practices Act.

I enclose for the record my letter of April 15, 1977, to the Senate Committee on Banking, Housing and Urban Affairs estimating the costs that would have been associated with the adoption of S. 305, a bill which included proposed versions of both the Foreign Corrupt Practices Act and the Domestic and Foreign Investment Improved Disclosure Act. As you know, this legislation was enacted as Public Law 95-213.

In my letter to the Senate Committee, I estimated that the cost to the Commission of the Foreign Corrupt Practices Act would be minimal and not susceptible to reduction to a specific dollar estimate while the total cost of the Improved Disclosure Act would be in the range of \$230,000 to \$470,000 with additional data file maintenance costs of \$31,000 to \$80,000 per year.

I do not believe that the changes made in this legislation between April 18, 1977 and its enactment call for any modification of that estimate and suggest that, but for slight increases due to inflation, it represents our current thinking.

Second, I offered to submit for the record a chart detailing Commission staffing levels since 1975 on a program-by-program basis. Such a chart is enclosed.

Finally, I was asked to comment on the impact of a failure to extend the deadline contained in Section 11(a) of the Securities Exchange Act of 1934 on small and regional securities brokers and dealers.

In my testimony before the Subcommittee, I indicated that Section 11(a), upon its full effectiveness, would have a significant impact on exchange members, and particularly regional and small members, by restricting members' ability to effect exchange transactions for their own accounts, the accounts of associated persons, and accounts with respect to which the members of their associated persons exercise investment discretion. Many regional exchange members have traditionally managed smaller institutional accounts to which Section 11(a) applies. Such accounts would include Keogh plans, pension trusts for local corporations, hospital and church trusts and build-

ing funds, cemetery and funeral trusts, professional corporations, and college and private school endowments. The ability of regional firms and small firms to attract this money management business historically has depended on their ability to offer lower overall charges by relying solely on brokerage and similar fees and not charging a separate management fee.

The Commission's concern over the effectiveness of Section 11(a) on May 1, 1978 stemmed in part from its belief that the Section could diminish the ability of regional and smaller firms to attract such business and to remain competitive. The Commission perceived that, if Section 11(a) prevented institutional accounts managed by regional exchange members from obtaining money management accounts in return for brokerage compensation alone, many of those accounts would likely seek to reduce costs by bypassing regional firms entirely. The Commission believed that such a pattern might develop because larger money managers, while charging a management fee, would be able because of the volume of their transactions to reduce to a bare minimum brokerage paid to unaffiliated exchange members for execution services.

The Commission is not aware of any precise data with respect to the dependence of exchange members on brokerage revenues generated by accounts over which they exercise investment discretion. While a few of the larger member firms have divested themselves of money management business, the Commission nevertheless understands that a large number of regional firms throughout the United States receive, and depend on, brokerage compensation from accounts under management to which Section 11(a) applies.

As you know, several events have occurred since I testified before the Subcommittee. First, the Commission has adopted several rules effective May 1, 1978 in order to address some of the problems which Section 11(a) appeared likely to cause upon its full effectiveness on May 1, 1978.

One of the rules adopted by the Commission in March, Rule 11a2-2(T), has made it possible for member firms and their managed institutional accounts to create new contractual arrangements, with appropriate consent by the account and disclosure of transactions related compensation to that account, so that the account does not have to terminate completely the management relationship previously established.

Second, Section 11(a) went into effect on May 1, 1978 since the Congress had not completed the legislative process needed to effect a postponement of the Section.

While we understand that some institutional accounts have elected to pursue the relief afforded by Rule 11a2-2(T), we do not currently know the extent to which that has been the case. In addition, the Commission does not have complete information concerning the effect Section 11(a) has had during the limited duration of its effectiveness or concerning the extent to which its rules have mitigated the adverse impacts of Section 11(a).

I hope that the above information is responsive to the Subcommittee's questions. Please let me know if I can be of any further assistance.

Sincerely,

HAROLD M. WILLIAMS,
Chairman.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., April 15, 1977.

HON. WILLIAM PROXMIRE,
*Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate,
Washington, D.C.*

DEAR MR. CHAIRMAN: This is in further response to your request of January 25, 1977 for the Commission's comments on S. 305. As you know, the Commission's views on this legislation were originally transmitted to the Committee in conjunction with testimony offered by Chairman Hills on March 16, 1977. Since that time the legislation has undergone considerable modification which has affected the impact it would have on the Commission's budget and it is therefore the purpose of this letter to offer an estimate of the probable costs to the Commission that would be associated with enactment into law of S. 305.

We believe that the likely cost impact on the Commission of the bill's prohibitions of certain corporate payments and its improvements in the

system of corporate auditing and accounting is minimal and, at present, not susceptible to reduction to a specific dollar estimate.

Section 203 of the proposed S. 305, on the other hand, can be cost analyzed. This section requires the Commission (1) to set up a disclosure program of reporting by any person who is directly or indirectly the beneficial owner of more than 5 percent of any class of a security as defined under the section, (2) to develop a centralized non-duplicative and minimum burden reporting system regarding such ownership in securities and to make available the collected information to government agencies and the public, and (3) to report to Congress within 30 months of the date of enactment of the bill on the effectiveness of the beneficial ownership requirements of the Securities Exchange Act and the desirability and feasibility of reducing or otherwise modifying the 5 percent threshold. Accordingly, cost estimates are provided for three phases of this disclosure program: (1) the development of a comprehensive reporting system, (2) creation and maintenance of a data base, and (3) the report to Congress.

I. The Development of a Reporting System. This development under Section 13(g) will provide necessary ownership information not now provided and will be integrated with other ownership reporting systems including those under Sections 13(d) and 16(a). Such rule-making activity likely would entail a review of the content of various ownership reporting requirements to assure that all data obtained are complete, comparable, and easily tabulated for computer purposes. We estimate that one and one-half staff years would be necessary. On the assumption that the person or persons responsible would have an average salary at GS-12 step 1, and adding supervisory time, it is estimated that the cost involved would be approximately \$38,000. It should be noted that we do not include the cost of reviewing reporting duplication under Section 13(f) (reporting by institutional investment managers) since the proposed rule and forms are not yet finalized, and, thus, a cost estimate of this review is not now feasible.

II. Creation and Maintenance of Machine Readable Data. We estimate a universe of 14,000 potential respondents (10,000 publicly held corporations with an average of 1.4 equity issues per corporation). While no data are available for estimating the number of 5 percent owners of these 14,000 issues, we believe that the average number falls somewhere between 1 and 5 and have estimated a probable range of cost figures accordingly.

Our estimated costs for creating machine readable data fall into four components.

(1) *Preconditioning of data.* We estimate that a GS-5 clerk can process 21 forms per day or 32 amendments per day and assume that clerks will have to update all original 13-D filings with the amendments filed at the Commission since 1968.

(2) *Key punching and verification.* We assume that data from each initial registration will require five data cards, that amendments require only two data cards, and that approximately 400 cards can be key-punched and verified by an operator in one day.

(3) *System Development and Program Formulation.* Costs estimated are only for creating the data file and do not include programming to access the data for retrieval.

(4) *Machine time.* Computer time for developing the data system is assumed to be 25 percent of the number of staff hours for system development. Time for data storage is also included.

Based on our analysis of the personnel required and their productivity and the number of forms and amendments likely to be filed, we estimate the cost associated with creation of the proposed data base ranges between \$89,000 and \$336,000 with annual maintenance cost to fall between \$31,000 and \$80,000. As noted earlier, we can only set ranges of possible expense here because of our lack of data as to the average number of 5 percent holders per issue. The comparable staff year figures, assuming an average salary at GS-7 step 1, are seven to 28 staff years for creation of the data base and three to seven for maintenance.

III. Report to Congress. Proposed Section 13(h) would require a report within thirty months after the date of enactment with respect to the effectiveness of the ownership reporting requirements and the desirability and feasibility of reducing or otherwise modifying the 5 percent threshold, giving

appropriate weight to a number of specific considerations. After the adoption of the rules drafted in Item 1 above, it is our belief that the report required by Section 13(h) likely would involve the review of information filed pursuant to that rulemaking and that the review and analysis of this information and a compilation of the report would involve four staff years; based on the same figures specified in Item 1 above, we estimate a total cost for the report of approximately \$100,000.

In summary, we estimate the total cost to the Commission of implementing proposed Section 203 of S. 305 to be in the range of \$230,000 to \$470,000, plus estimated data file maintenance cost of \$31,000 to \$80,000 per annum. Of course, additional unestimated costs would be borne by the private sector.

I hope this information will be helpful to the Committee. Please let me know if I or my staff can be of further assistance.

Sincerely,

HAROLD H. WILLIAMS,
Chairman.

STAFFING LEVELS BY PROGRAM FISCAL YEARS 1975 THROUGH 1978

Program	1975	1976	1977	1978
Full disclosure.....	593	527	529	510
Prevention and suppression of fraud.....	770	734	748	745
Supervision and regulation of securities markets.....	265	264	287	285
Public utility holding company regulation.....	27	24	26	26
Investment management regulation.....	176	204	209	208
Corporate reorganizations.....	41	41	41	41
Operational and business statistics.....	39	36	38	38
Executive and staff functions—includes administrative functions.....	233	230	239	239
Agency total.....	2,144	2,060	2,117	2,092
Funding level (thousands).....	\$44,427	\$49,291	\$56,270	\$58,290

Mr. ECKHARDT. Do you have this chart here?

Mr. WILLIAMS. Yes.

In 1975 our staff totalled 2,144 as contrasted to the——

Mr. ECKHARDT. On page 12 it says the Commission will nonetheless have fewer authorized personnel than in 1975.

Mr. WILLIAMS. That is right. We are talking about the 1979 estimate of 2,132, which would bring us below the 2,144 figure which I just mentioned. To break this disparity down further I will have to use 1978 figures since I don't have fully comparable 1979 data at hand.

Full disclosure was at 593 in 1975. The comparable figure for 1978, is 510. So a substantial part of the reduction can be accounted for there. Enforcement was down from 770 in 1975 to 745 in 1978, a reduction of 25.

The figure for supervision and regulation of securities markets was up 20 from 265 to 285 during that 4-year period.

Investment management regulation was up 30, from 176 to 208. So essentially what we are seeing here, it came out of full disclosure, No. 1, to some extent, out of suppression of personal fraud, went into regulation of securities market and investment management.

Mr. ECKHARDT. Another thing we were concerned about in the hearings last year, one was that the ratio of professional-clerical help in the division was 5 to 1. We had testimony that some of the lawyers were typing some of their own briefs, matters of that nature. Has anything been done about that?

Mr. WILLIAMS. Not very significantly, no, sir. It has changed within one of the divisions. But on the aggregate as far as the Commission as a whole is concerned it has not changed. The only way it has changed qualitatively is that through some of our automation through word processing machines and activities of that sort we are able to provide better facilities for the clerical help to use so that they become more efficient and will actually be able to produce more work.

But in terms of ratio is hasn't changed. We still have some of the finest-lawyer-typists in Washington.

Mr. ECKHARDT. Last year there was only one person part-time engaged in surveillance of the options market. Due to the wide opportunity for abuse without appropriate monitoring, what is being done?

Mr. WILLIAMS. Essentially in Washington there is still one person primarily involved in that. We have some additional emphasis in our regional offices, not as an exclusive undertaking on the part of any individual but in connection with other duties. And as you know, sir, we have our options study which is underway and in which I believe we have something on the order of 27 people involved essentially full time. That is a primary major resource allocation, drawing people from throughout the Commission for that study.

Mr. ECKHARDT. You told us about obtaining new space. I think that is the Home Loan Bank Building?

Mr. WILLIAMS. Yes, sir.

Mr. ECKHARDT. Is that going to alleviate or has it alleviated the situation we found about doubling up in offices, and locating some of your lawyers in the basement and so forth?

Mr. WILLIAMS. We are not yet occupying the space. But when we do, which should be in the next several months, we will still be below average by any normal measurement on space occupancy per capita. So the problem will be alleviated but not eliminated.

Being a small agency, we are a very interactive agency. The addition of a third location for our people does create new problems for us in terms of the effectiveness of the Commission. As a tradeoff, we are delighted to have additional space. But it is far from being an optimum solution.

Mr. ECKHARDT. There seem to be more accounting-related problems before the Commission. Inflation accounting, oil and gas, questions dealing with auditors' responsibilities and the Foreign Corrupt Practices Act, to name a few. Yet the Commission has been without a chief accountant for nearly 2 years, as I understand. What are the plans to appoint a new chief accountant?

Mr. WILLIAMS. We have been functioning with an acting chief accountant who has performed ably in the role. We continue to recruit for an individual, our preference being probably out of the academia at this point. But to find the kind of person who fits the need, and whom we can attract within the compensation structure is a difficult task. We are working on it and hope to have the position filled in the near future.

Mr. ECKHARDT. How about the staff? Is it necessary to beef up the staff?

Mr. WILLIAMS. The staff is being beefed up. And it is necessary.

Mr. ECKHARDT. Within the last 6 months the division of investment management regulation has lost a substantial number of key personnel including the division director. What plans does the Commission have to reinvigorate this division?

Mr. WILLIAMS. I expect to have a new director appointed in the very near future. I would think that we will be making important additions to the senior staff of that division.

Mr. ECKHARDT. I have been pretty much concerned about the effect of having revolving door legislation, as it is called. There is, as you know, legislation awaiting the Rules Committee action. If enacted the bill would prevent certain key agency employees from practicing before the agency within a year after leaving Government service? Would this bill have any effect on your operations? Or your recruiting ability?

Mr. WILLIAMS. Mr. Chairman, we are very concerned about the legislation. In our judgement, while we clearly share the types of concerns that give rise to legislation, our sense is that it may well be an overreaction as far as this Commission is concerned. We would be seriously affected both by the prospective loss of some of our key people and the recruiting problem we would have in trying to replace them.

Our conduct rules are strict and are strictly enforced, in our judgement. So the intent and spirit behind this legislation succeeds very well without the bill.

Mr. ECKHARDT. As you know, I share your views on that. I appeared before the Committee.

Mr. WILLIAMS. I appreciate that.

Mr. BROYHILL. Could I ask a question? How will this affect your ability to attract accountants? CPA's I suppose conceivably could be working for—

Mr. WILLIAMS. If they were working for one of the firms, it is conceivable that it would have a negative affect.

Mr. BROYHILL. They are working for accounts that are registered.

Mr. WILLIAMS. Our primary concern, Mr. Broyhill, would be for lawyers, our senior staff people who are predominantly lawyers. That is the place we have been seriously affected.

Mr. BROYHILL. Thank you.

Mr. ECKHARDT. Would you proceed?

As soon as Mr. Broyhill gets back I would like to ask one other question. I understand OMB has an impact on your budget. We have had some concern on this committee with the effect of the authority of OMB on influencing the budget of independent regulatory agencies. In a sense it seems to us the OMB is more involved with the executive family than the independent regulatory agencies are intended to be as their names implies. Would you care to discuss the situation if this has existed, this time with respect to OMB's actions?

Mr. WILLIAMS. Well, sir, to give you the whole sequence, I described for you in my testimony the process we went through in the Commission to arrive at our resource needs for the 1979 budget and all the disciplines that were built into that process.

When all the numbers got to me the division requests were for 132 additional people. When I finished with it, the request had been pared down to 87 more personnel in 1979. The request as approved by OMB was for 40. That was the sequence. That is what transpired.

I think we can fully justify 87. Obviously my staff thinks we can fully justify 132. As to whether OMB should be involved in that process, I will accept the committee's judgment on that.

Mr. ECKHARDT. If you would, you may proceed.

Mr. WILLIAMS. Thank you, Mr. Chairman. I have with me Mr. Andrew M. Klein, Director of Market Regulation.

The legislative proposal to extend Securities Exchange Act Section 11(a)'s effective date until Nov. 1, 1979, which the Commission has recently sent to the subcommittee for its consideration, and which has been introduced as H.R. 11140, warrants favorable action by the subcommittee and immediate enactment by the Congress. As you know, unless H.R. 11140 becomes law, section 11(a) will become fully effective on May 1 of this year. As a result, on May 1, all exchange members will be prohibited from effecting exchange transactions for their own proprietary accounts, the accounts of their associated persons, and any account which they or their associated persons manage. There are statutory exceptions to that prohibition, but the practical effect of section 11(a)'s full effectiveness will be to curtail dramatically the ability of many exchange members and exchange member firms to conduct business for their own accounts and many customer accounts.

The Commission's support for the extension of section 11(a)'s effective date is based on its concern that full implementation of the section's trading prohibitions on May 1 of this year would be premature in light of the continuing rapid pace of economic, technological and regulatory changes in the markets. Since the Congress last considered section 11(a) during its formulation of the 1975 Amendments to the Securities Exchange Act, the securities markets have changed in significant ways. Those changes have been accompanied by shifts in the economics affecting broker-dealers, financial institutions and the customers of those intermediaries.

Changes in the American economy have unquestionably adversely affected investor confidence and interest in the markets, particularly the equity markets. In turn, the ability of broker-dealers to command stable income streams from equity underwritings and other equity-based activities has changed and, in many cases, been diminished. These effects, moreover, have been magnified greatly by elimination of fixed commission rates. The industry has been the institutional brokerage rates drop more precipitously than was generally predicted in 1975. The result has been a virtual elimination of institutional brokerage as an important profit center for many firms. Some firms have been forced to go out of business while others have merged with larger firms. And, particularly in the last year, we have seen an emerging trend toward consolidation and concentration in the industry as a number of very well known and major firms combined to strengthen or shore up their competitive positions.

Substantial uncertainty about the future adds to these difficulties. The Commission has made it clear that there will have to be sig-

nificant progress toward a national market system during the next year. Many firms in the industry—including a number of regional and smaller firms—will face complex planning decisions and uncertain costs as they gear up for participation in a national system. The introduction of automated quotation devices and of other technological innovations has, we are told, already increased the fixed costs brokerage firms must now incur. And the developments yet to come may further increase those fixed costs and make it even more difficult for smaller firms to compete.

Against that background, the full effectiveness of section 11(a) on May 1, 1978 is a cause for concern. Many regional and smaller firms, for example, have indicated to us that their ability to remain competitive will be substantially diminished. By effectively requiring that they cease managing relatively small accounts for brokerage charges, they reason that there may be a substantial reduction in the availability of money management services to accounts of that size. In turn, the beneficiaries of those accounts may be required to shoulder additional costs to obtain the services they currently obtain from such firms. Such a result would appear clearly to be at odds with both 11(a) and the overall purposes of the 1975 Amendments.

The Commission's recommendation for a delay in section 11(a)'s full effectiveness is not based solely on competitive considerations. While the Commission is concerned that section 11(a) may diminish the ability of many regional and smaller firms to remain competitive, the Commission also believes that it may be inappropriate to apply section 11(a) to the securities markets at a time when they are undergoing dramatic change.

The markets have changed considerably since 1975, when the Congress enacted section 11(a). There have been various developments which will gradually provide the capacity to implement a best execution rule. Fixed commission rates have given way to negotiated commission rates. A consolidated tape now reports trades on all domestic markets in exchange-listed securities. There will soon be a composite system for displaying quotes from all market makers in exchange-listed securities.

In January of this year, the Commission announced a timetable for certain stages of the national market system, including the establishment of various order-routing, market linkage and limit order protection systems. Nonetheless, it is simply too soon to tell what the ultimate configuration of that system will be or how it will impact on market participants. On one hand, the creation of a national market system certainly does not mandate any abandonment of existing market centers. On the other, we can anticipate some realignment of the provisions for access to the markets as the order routing systems and the market linkages become a reality. Through that process the advantages of access and proximity to the markets, which were once limited to those physically present on exchange floors, may become even more broadly distributed than they presently are.

The pace of change that has continued since 1975 and that will be accelerated during the next several months as we move toward a national market system lead the Commission to conclude that this is

not the right time for section 11(a) to become fully effective or to impose rigidity where flexibility is essential. If we were dealing with a relatively stable system, it would be possible to predict how Section 11(a) would ultimately affect the markets and their various participants. The Commission might also be able to judge with reasonable confidence how modifications in the application of section 11(a) through rulemaking might alter those effects over the long term. Since the markets are still rapidly evolving, however, that level of confidence is not possible.

The Commission is also concerned that enforcement of the Section presents substantial problems. For two and a half years the Commission has conducted a rulemaking dialogue with those who will be effected by section 11(a). On the basis of that dialogue, it currently appears that there is no common understanding among those to whom section 11(a) will apply as to what the section requires and how firms must alter their businesses to comply.

From the outset and continuing to this time, there has been substantial controversy as to the scope of section 11(a)'s prohibitions, the application of the section to the activities of floor members of exchanges, and the methods that must be devised by exchanges to assure compliance with the section.

The Commission is concerned that many in the securities industry, for example, may be unaware of the subcommittees recent statement to the effect that the section makes it "clearly unlawful" for member firms to retain transaction-based income for participating in any way in effecting trades for managed accounts. Implementation of the section in a manner compatible with that statement, in our view, would have significant effects—effects many in the industry apparently do not understand can occur. For many firms which plan to comply scrupulously with the section, the absence of certainty as to its intended meaning and application has frustrated sensible business planning—business planning that simply cannot be concluded in the time that now remains before May 1. Failure to postpone full effectiveness of the section will have harsh consequences for such firms. Those firms which have found it relatively easy to prepare for full effectiveness of the section—because, in light of their business mix, restructuring could be accomplished simply—would not be injured by the extension we recommend.

The Commission will soon announce the conclusion of its rulemaking proceedings in this area. We hope in that process to clarify some of the ambiguities in section 11(a) and to provide some measure of certainty concerning its scope and application. However, rulemaking alone will not solve many of the problems that immediate effectiveness of section 11(a) are likely to cause. Even those who arrange their business in a way which does conform to section 11(a)'s requirements, for example, may be tempted to engage in reciprocal practices to recapture revenues which the section compels them to forego. Such practices would be difficult to detect and prevent.

During the 18-month period provided by the extension of section 11(a)'s effective date, the Commission expects that there will be substantial progress in the steps toward development of the national

market system. In addition, the Commission, the exchanges and their members will have an opportunity to plan more deliberately for the implementation of section 11(a). Within the next year, the Commission also should have substantially completed an intensive study that we have recently begun on the economics of the securities industry. Hopefully, we will then be in a better position to evaluate, among other things, what trading patterns will likely occur in a national market system and how the configuration of such a system will affect the financial viability of market participants. In view of those needs, which the Commission see largely as a matter of timing, we urge the Congress to act now to provide the requisite period for adjustment. Also, since most of the same factors which have persuaded the Commission that the full effectiveness of section 11(a) should be deferred are equally applicable to post-May 1, 1975 exchange members, we believe that H.R. 11140 should be amended to postpone until Nov. 1, 1979, application of the section to all current exchange members. In our Feb. 22, 1978 submission to the subcommittee, we provided an alternate legislative proposal to that effect.

In making these recommendations, we are not unmindful of the possibility that they may be opposed by institutional money managers which are not members of exchanges. Their reasons for opposing the recommendations have some merit. Among other things, section 11(a) appears to have been intended to insure a fair field of competition in the business of providing money management services by preventing members of exchanges engaged in that business from taking undue advantage of their privileged positions as exchange members to attract and retain institutional accounts by acting as both money managers and broker-dealers with special access to exchange markets. Nonmember institutional money managers, of course, were not in a position to offer and avail themselves of the benefits inherent in exchange membership. Those who disagree with our recommendations may urge that the grandfather provisions of section 11(a) have already permitted an existing competitive disparity to persist for too long a time and that the Congress should not now continue that disparity for an additional period. As we have indicated, however, we think that the competitive advantage has been significantly diminished by the events of the last 3 years, the economic advantages having been largely, if not entirely, eliminated. In any event, the problems associated with immediate full implementation of section 11(a), including consequences which may be inconsistent with developments flowing from implementation of a national market system, outweigh such possible competitive difficulties as may be continued briefly for nonmember institutional money managers.

On behalf of my fellow Commissioners, I would like to thank the subcommittee for affording the Commission this opportunity to present our views on the postponement of section 11(a). I would, of course, be pleased to answer any questions the members of the subcommittee may have.

Mr. ECKHARDT. On the third page of your letter to the Speaker, attaching your proposal, it is stated that as a result of negotiated rates which have eliminated incentive for institutional members to join exchanges, subsection 11a is no longer needed to redress a competitive imbalance.

That being the case, are you really recommending our repealing the section.

Mr. WILLIAMS. No, sir. Only that you delay full implementation.

Mr. ECKHARDT. Only delay enactment.

Mr. WILLIAMS. We are not recommending repeal. We are only asking for additional time to work through such problems as those associated with implementation of the national market system and then being able to implement the section in a fashion consistent with the total development of the system.

Mr. ECKHARDT. If an 18-month delay is obtained, what kinds of things would the Commission be able to do by rulemaking or otherwise?

Mr. WILLIAMS. I really can't tell you what we would do by rulemaking. Most important of course is the implementation of the national market system itself, or at least many of its major components. The second dimension of it would be our economic study of the industry which would give us a much better handle on the current economics and the economic trends within the industry itself and on what it takes for that industry to be able to remain viable. We will have an opportunity to evaluate trading patterns and marketing patterns as they evolve with the national market system and as result of our rulemaking under 11(a).

With the opportunity to learn from the kind of experience that we would hope and expect an 18-month delay would afford we would be able to implement it sensibly in the light of more stable economic and market conditions.

Mr. ECKHARDT. Can you mention anything the Commission might do to alleviate some of the adverse effects of 11(a) between now and May 1?

Mr. WILLIAMS. I don't know how to answer that, Mr. Chairman, until we have completed our rulemaking. To an extent, ERISA rulemaking to ensure a compatible result in light of section 11(a) may provide additional clarity.

Mr. ECKHARDT. Some of the institutions have mentioned to us that in the last couple of months commission rates have gone up fairly uniformly among brokerage firms and institutions have suggested there might be collusion among the firms and in any event that the higher rates are rekindling the incentive to join exchanges. Has the Commission detected any evidence of price-fixing?

Mr. WILLIAMS. No, sir, we haven't. Let me answer the question with a little background. Without in any way intending to be an apologist for the securities industry, this is an industry that is just learning how to live with the competitive environment. As indicated in several public statements, I think there is reason to believe that institutional commission rates have declined beyond the point where they should have in terms of economic justification on the part of the industry itself. That has been a matter of some very real concern.

There is a contention on the part of some that the ability to negotiate at least as between the smaller broker dealers and the larger institutions is an uneven negotiating process. Some in the industry characterize it as no negotiation at all.

But there is nothing that I am aware of at this point to indicate any price-fixing. Moreover, I think there is an open question as to

how profitable institutional business is in the context of these higher rates. That leaves open therefore the question of whether there would indeed be a real economic incentive in the competitive market situation for institutions to seek exchange membership.

Mr. ECKHARDT. The Commission has proposed alternative legislation which not only would extend the application of 11(a) to those firms which join the exchanges before May 1, 1975 but also to those which joined before Feb. 1, 1978. Does the Commission have a preference as to which proposal should be enacted?

Mr. WILLIAMS. Our preference would be that the grandfather date be moved to February 1 or some similar date in the recent past.

Mr. ECKHARDT. If H.R. 11140 is enacted do you feel the Commission could and would grandfather the remaining firms by rule?

Mr. WILLIAMS. I don't believe we would have clear authority to as that under the act, but we would have to give candid consideration to that question.

Mr. ECKHARDT. It has been suggested that the implementation of 11(a) would cut off certain necessary revenues to broker-dealers which will in turn exacerbate the current trend toward concentration in the industry. I gather that you agree that is a danger from your statement?

Mr. WILLIAMS. We share that concern very much, sir, yes.

Mr. ECKHARDT. Your memorandum suggests that implementation of 11(a) which applies only to members of exchanges could encourage firms to leave exchanges. Clearly the incentive will be there. But does the Commission have any evidence that this is occurring or will occur?

Mr. WILLIAMS. No, sir, we do not.

Mr. ECKHARDT. Can you think of any rationale for this dichotomy of treatment by 11(a) between members and nonmembers?

Mr. KLEIN. If I might try to respond, Mr. Chairman, I think that at the time the legislation was formulated, exchanges were perceived as being the primary loci for trading. Access to exchange floors was the only means of direct access to the basic trading mechanism of the markets. To not be an exchange member was not to have that kind of access at least in the markets of 1975. That fact was what mattered for purposes of framing these kinds of statutory prohibitions.

This disparity in the treatment of exchange members and nonmembers is really a function of who has direct access to the basic trading mechanism of the markets, which has been the exchange floors. I am not sure if that logic continues to support this disparity today or will tomorrow in view of the kinds of market changes we are experiencing.

Mr. ECKHARDT. Mr. Broyhill?

Mr. BROYHILL. Let me ask you a question or two concerning your estimate of the magnitude of the problem. Mr. Eckhardt asked you a question as to whether you feel that resources will be drained away from the very market it is now engaged in. Do you have any estimate of the magnitude of this?

Mr. WILLIAMS. No, sir, we can't quantify it at this point. We don't have the economic data to base an estimate on. Even if we did,

it would still be just an estimate. Judging from what the people in the industry say, the magnitude would be significant.

Mr. BROYHILL. Do you have any estimate as to the percentage of people in the industry who would be affected? Would it be practically all 75 percent? Half?

Mr. WILLIAMS. I can't give you that on a percentage basis either. My concern though are that, first, it would be substantial and that, second, it would be skewed against those who could probably least afford it in terms of just their ability to continue to be viable in the kinds of economic and market transition circumstances we are living with.

Mr. BROYHILL. In your statement you indicate that it will impact, have the greatest impact, on small and regional firms.

Mr. WILLIAMS. That is right.

Mr. BROYHILL. You are indicating that these type firms are more engaged in these practices than, say, the larger firms that are headquartered in New York or in other metropolitan areas?

Mr. WILLIAMS. Not necessarily. But some of the larger firms are more deeply involved than others. Many of the larger firms that are more deeply involved are better able to work on a fee basis, for example, if they are so inclined and also, even if worst came to worst, could afford to lose that business without affecting their economic viability. In the context of what the committee articulated last year, it appears that some regional firms who work on a brokerage basis only on managed accounts would be more severely affected if they were unable to derive transaction-based income on managed accounts, which in many instances are relatively small accounts but for many firms are a good part of their bread and butter.

Mr. BROYHILL. But you can't give us any idea of the magnitude?

Mr. WILLIAMS. I am sorry, I cannot.

Mr. BROYHILL. Any lower or upper limits even?

Mr. WILLIAMS. Let me go back to the drawing board to see if I can come up with some kind of a ballpark—I am not proud of the fact that we don't have the data base to do it. But let me see if I can come up with something.

Mr. ECKHARDT. Without objection we will leave the record open at this point.

[The information requested was not available to the subcommittee at the time of printing.]

Mr. WILLIAMS. Thank you.

Mr. BROYHILL. Let me see if I can get a better handle on this. Are you saying that a lot of these firms who are involved in managing accounts could not derive enough revenue from doing this on a fee basis, to separate the two?

Mr. WILLIAMS. At least in relation to a number of the smaller firms and the smaller kind of accounts that they deal with. They do not receive a fee. Their compensation is transaction related.

Mr. KLEIN. Mr. Broyhill, the problem we perceive is that some of these smaller accounts, which have been managed for the brokerage alone, that if they are forced into a position where in order to obtain money management they must pay a money management fee, rather than simply rely upon the brokerage, might be forced to go

somewhere else for money management. They might go to someone who, in giving the brokerage to a third party for execution purposes, would be able to command the lowest possible commission rate. This is likely to represent an increase in total costs to the beneficiaries of such accounts.

Mr. BROYHILL. That is the reason for your statement on page 3 where you come to the conclusion that the effect of this May 1 deadline will effectively require that they cease managing relatively small accounts for a brokerage charge.

Mr. WILLIAMS. That is right.

Mr. BROYHILL. That doesn't mean you have to get out of the business of managing the account. They can still manage the account.

Mr. WILLIAMS. For a fee.

Mr. BROYHILL. You are saying they probably couldn't compete. Is that what you are saying?

Mr. KLEIN. We are concerned about that.

Mr. BROYHILL. Against whom?

Mr. KLEIN. Against larger firms which may be in a better position to command that brokerage for the account be done for a very low rate. That may not be within the capacity of a relatively small member firm which is used to doing those transactions on its own but which doesn't charge a separate management fee. Such small firms simply may not have enough business to obtain the lowest commission rate from someone else.

Mr. BROYHILL. I don't have any more questions right now.

I probably will for the panel.

Mr. ECKHARDT. Mr. Oppper.

Mr. OPPER. Chairman Williams, in your statement you note that 11(a) appears to have been intended to insure a fair field of competition in the business of providing money management services by preventing members of exchanges engaged in that business from taking undue advantage of their access to the floor.

Mr. Stuart Nelson, from Sanford Bernstein & Co., who will testify later on the panel, suggests that perhaps the problems of most of the broker dealers who would be adversely affected by the implementation of 11(a) might be alleviated if we break the definition of "customary brokerage" down into its various components.

He suggests a customer brokerage include such elements as upstairs trading, floor execution, floor comparison, purchase and sale comparison and clearance, and that the institutions can perform all of the various components competitively with brokers except for floor execution.

Accordingly, he urges, in order to maintain a competitive balance all that perhaps has to be done would be to allow the broker to charge for the various components with the exception of floor execution or to charge a fee net of floor execution.

Have you thought about or do you have any comments on that?

Mr. KLEIN. I have only had an opportunity to look at this proposition just this morning. The difficulty that strikes me, at first blush, is that it is easy to say, "Well, there are four components to effecting a transaction and we are going to charge a little bit for each one of them." It is difficult to be sure, however, that some claiming to charge for only three of those four functions in fact is doing

only that. One cannot easily ascertain whether a bona fide rate is being charged for a bona fide function instead of for that function plus something else. But this would require further consideration from us before we could give any informed assessment of the viability of the suggested approach.

Mr. OPPER. But it is something you will consider?

Mr. KLEIN. Certainly.

Mr. WILLIAMS. Which suggests, I gather, that the only activity that would need to be separately paid for, unbundled from the whole package, would be floor execution itself.

Mr. OPPER. That is my understanding. Because that is the only area in which the brokers clearly have a competitive advantage over the institutions.

Mr. WILLIAMS. That resembles one of the early Commission proposals that generated a whole range of questions.

Mr. KLEIN. I gather that this proposition is that the section ought to be implemented on a basis which would require a member who was managing an account to insure first that someone else executed trades for the account and that the person executing the trade for the account be separately paid for that function. But aside from that, any compensation that the money manager originating the transaction wished to retain in connection with the performance of other functions in that trade could somehow be retained. It does strike me that that this approach attacks the underlying rationale for the suggestion that transaction-related income should not be retained by members engaged in money management.

Mr. WILLIAMS. It will take some more thought on our part to pick through all the implications.

Mr. OPPER. I suppose the problem with 11(a) is trying to balance that against the other perceived purpose of 11(a)—that is, to create some competitive equality with brokers' and institutions. If these other functions are being performed by institutions, it would seem to be inequitable not to permit the broker to perform them.

Mr. KLEIN. I think there are other kinds of considerations that would enter into this assessment. The extent to which a nonbroker dealer money manager who was performing these functions and charging for them on a transaction by transaction basis is how comfortable one is with the idea that he is not a broker dealer. I don't understand section 11(a) to suggest that in order to compete as a money manager what you have to do is to be a member of the exchange, a broker dealer, but rather quite the contrary.

Mr. WILLIAMS. Also, by looking at the competitive balance, the Commission in a broader sense recognizes and deals almost on a continuing basis with the recognition that a number of stated purposes to the act are to be achieved. But the rate at which one or more of these purposes is achieved, or where the priority should be placed in arriving at an ultimate national market system that achieves all these purposes, does require a certain amount of priority setting and orchestration, if you will.

This is one instance where the timetable is statutorily fixed as we try to arrive at the national market system with component objectives and all the other objectives being achieved. And we find

that the effective date is dysfunctional because it comes at the wrong time in the sequencing and the developing of the system as a whole.

Mr. BROYHILL. It is my assumption that the Commission does intend to enforce 11(a) after May 1 if there is no legislation?

Mr. WILLIAMS. Yes, sir, we do. We expect to propose the rules in the very near future. We do recognize that the time frame is short and that to the extent that the industry will need to do certain things to put themselves in a position to comply with the requirements of 11(a), this will involve our good judgment in terms of just how rapidly and how vigorously it is enforced.

Mr. BROYHILL. Will you have rules in place by May 1?

Mr. WILLIAMS. Yes, sir, they will.

Mr. BROYHILL. I think you might have gotten into this. I wonder why you haven't recommended repeal of 11(a) after all the extensive arguments you have in your statement.

Mr. WILLIAMS. Our sense is that we ought to look at 11(a) in the context of a national market system and then implement it. If it is dysfunctional at that time, we may want to come back and talk to you. But that is not our plan. Our plan is that it ought to be implemented. You have told us that you want it. We will find a way to implement it in the context of the system. We just don't know how to do it now in a way that is sensible and that fits with the evolution of the system rather than working against it.

Mr. BROYHILL. Mr. Chairman, I have a couple of questions in regard to other areas. Is it all right if I ask those now?

Mr. ECKHARDT. Sure.

Mr. BROYHILL. I have introduced a bill because certain concerns have been expressed by me about the effect of certain SEC rules, particularly as they apply to small business investment companies. I understand you have some hearings coming up on the subject?

Mr. WILLIAMS. We will be commencing hearings in April, yes, sir.

Mr. BROYHILL. I assume that these will be addressing rules 144 and 146?

Mr. WILLIAMS. Yes, sir.

Mr. BROYHILL. Your hearings will start in April and continue for how long?

Mr. WILLIAMS. I don't recall.

Mr. BROYHILL. You don't have the exact date?

Mr. WILLIAMS. We have three sets of hearings. We will need to phase these. My recollection is they will begin about the last week in April and should continue for something on the order of 3 weeks thereafter. We will be meeting in a number of cities around the country so we can get to where the small businesses are and try to get a more sensitive and detailed response.

Mr. BROYHILL. Will you have the hearings structured in such a way that the witnesses will be addressing certain specific topics? Is that what you are saying?

Mr. WILLIAMS. Once we get the witness list we will know how to organize it. We are inviting witnesses to tell us what their problems are so we can address them squarely and do something about them.

Mr. BROYHILL. I would be happy if you could share a copy of those and the topics and so forth.

Mr. WILLIAMS. Certainly.

Mr. BROYHILL. Has the Commission and the staff resources to conduct any studies to try to give some picture of the impact of the SEC rules on small business, how it affects their ability to generate capital?

Mr. WILLIAMS. To some extent but not enough. In conjunction with the Advisory Committee on Corporate Disclosure that worked with the Commission for about a year and a half, the Advisory Committee undertook to determine what the cost was of making a reg A offering. I recall it was something on the order of \$125,000. When you talk about a half a million dollar offering, that is too much money. That is what has triggered us to take a look at how we can restructure this so we can find a better way of balancing our concern for the investor concern, which in many ways is greater in a small, start-up operation, and that need of that type of company for capital.

Mr. BROYHILL. Thank you, Mr. Chairman.

Mr. ECKHARDT. Thank you very much.

Mr. WILLIAMS. Thank you.

Mr. ECKHARDT. Will the panel of broker dealers come forward?

Gentlemen, do you have any preference as to the order in which you go? Have you made arrangements among yourselves? Shall I just call on you in the order of listing?

You may if you desire ask leave to put your statements in the record and speak informally. Or you may speak from your statement, whichever you prefer. Your statements are relatively short, I assume.

Mr. Zicklin, of Neuberger & Berman, will you proceed first?

STATEMENTS OF LAWRENCE ZICKLIN, ON BEHALF OF EIGHT NEW YORK STOCK EXCHANGE FIRMS; BERNARD H. GARIL, VICE PRESIDENT, OPPENHEIMER & CO., INC.; STUART K. NELSON, MANAGING DIRECTOR AND GENERAL COUNSEL, SANFORD C. BERNSTEIN & CO., INC.; AND THOMAS ROULSTON, PRESIDENT, ROULSTON & CO., INC.

Mr. ZICKLIN. Thank you, Mr. Chairman.

Mr. ECKHARDT. Would you identify yourself for the record?

Mr. ZICKLIN. My name is Lawrence Zicklin. I want to thank the subcommittee for this opportunity to testify. I have been in this industry almost 19 years, almost half of which was spent with a large retail brokerage operation and the second half with Neuberger & Berman, which is a small investment adviser and broker. I was just talking to some of the people on the panel. I suspect we are a regional broker because we only have one office and that is in New York. I guess that makes us regional.

I have never appeared as a witness before a congressional committee. I appear today on behalf of eight New York Stock Exchange firms with an aggregate money management business exceeding \$2 billion who share a common interest in maintaining their positions as both money managers and member firms. These firms are: David J. Greene & Co.; First Manhattan Co.; Herzog; Heine & Co.;

Neuberger & Berman; Reich & Tang, Inc.; Stralem & Co.; Weiss, Peck & Greer; and Wheat, First Securities, Inc.

At one point we were nine firms jointed together to respond to the problems posed by section 11(a). Since that time one of the firms has been forced by virtue of economics to merge and disappeared from the scene. That was about 6 or 8 months ago. A second firm saw its money management business reduced to a level which made it uneconomical for it to continue in our group. Wheat, First Securities has joined our group at a later date because of its increasing concern regarding the impact of section 11(a).

Our group has been interested in this problem for 2½ years. We have written two memoranda to the SEC in response to its requests for comment. We have made numerous visits with the SEC staff in an attempt to seek clarification, the latest of which was less than a month ago.

At that time, two of us saw four members of the staff, presented a list of problems and were told honestly and directly by an informed staff that they weren't sure of the answers to our questions which depended on final rules which were yet to be written. We have sent individual letters to the Commission and to the Congress. Another of our members testified before this subcommittee. We have met with the New York Stock Exchange leadership and I think convinced them that there were serious problems with section 11(a). We have had countless meetings within our group and with counsel in the hope that we could come up with a plan that would allow us to maintain our businesses and be viable. All this was done during the period when our real business was much in need of our limited talents.

We strongly support H.R. 11140, which would delay the effective date of section 11(a) for 18 months. We also urge the subcommittee to enact a comparable delay under ERISA. In fact in July 1977 we wrote to the SEC and urged them to seek a 2-year delay in the implementation of section 11(a). At that time we realized that the responses of 1975 were not answers to the problems of 1977. Section 11(a) is certainly not an answer to the problems in 1978. Due to changing conditions in the business, most importantly the advent of negotiated rates, the condition of member firms has deteriorated.

The surge of so-called mergers—in my judgment these are liquidations—is a direct result of the deteriorating economics of the brokerage industry. We also recognized that more experience with negotiated rates and further information about the evolving national market structure would be needed before section 11(a) could be properly assessed and intelligently implemented. We were also aware that a period of adjustment would be necessary between adoption of SEC regulations under section 11(a) and the effective date of that section. We emphasized that given the critical need for lead time for business planning the real deadline for SEC action on regulations under section 11(a) was October 1, 1977, not May 1, 1978.

Our posture hasn't changed. The SEC should be complimented for recognizing the inherent difficulty in writing acceptable regulations given the changes in market structure since 1975. We are now 2 months away from the implementation of 11(a) and I know I

speak for our eight firms when I tell you that we still don't fully understand what section 11(a) means. There are a myriad of difficulties with regard to definitions; no rules have been written; and our business decisions necessarily await those rules and definitions. We have candidly admitted to these clients who have come to us with questions that we just don't know when regulations will be adopted or what they will say. The timing is now impossible for us. We will have problems negotiating new arrangements with clients; we will have advisory agreements to rewrite; prospectuses must be altered. Institutional clients will have to secure action by their various boards after consultation with counsel. This process cannot be completed in 2 months. And 2 months assumes that we have definitive regulations this afternoon. I would ask you to put yourselves in our position. How do we cope with this situation?

For those member firms in the money management business—and I mean money management both on a contractual basis or as a matter of practice and fact—the choices are rather basic. Depending on the definitions and regulations, we will either be in or out of the advisory business. There are now three definitions of the statutory term "effect." One definition puts us out of one business; one definition leaves us in both businesses; and the third definition leaves us in both businesses; and the third definition involves lengthy business restructuring. At this moment in time the regulations that the Commission has not yet promulgated will determine our business future. We have been in business almost 40 years; 60 days for major business restructuring is simply unfair.

We have recently reviewed each of our 6,500 accounts to determine the impact of section 11(a) on each one. To our dismay, we wound up with a large number of accounts which were in the "maybe" pile. It is not easy to manage a business with a "maybe" pile.

We also have to ask ourselves can we remain members of the various exchanges to which we now belong? Considering that we have been members of some exchanges for almost 40 years, this is an important question for us. I would ask the subcommittee members to put themselves in the position of a stock exchange member firm with an advisory business, not understanding whether or not it can remain in the advisory business or remain a member of various exchanges, depending on the rules and definitions yet to be issued, and facing a deadline only 2 months away. I am not attempting to amuse you when I say that revision of our computer programs will take more than 2 months. And getting our clients to recognize a new set of rules and the necessity of changing our arrangements, fees, and brokerage allocation will take much longer.

You will not be surprised when I tell you that most of my partners, and indeed most of the key personnel of our group, expect more certainty from Government regulation in an industry as highly regulated as we are.

The problems that we see and have seen for these past 2 years are still not recognized by much of the industry. We have asked for the support of other firms and were shocked to find that some member firms didn't believe they were affected by section 11(a). Their rationale was: "We don't get any fees, we have no discre-

tionary powers; therefore, we are not affected." When we pointed to the broad definition of "discretion", we were assured that the Government would never go so far. I submit to you that the imposition of 11(a) on May 1, 1978, will provoke either angry reactions or a rash of new enforcement proceedings.

If section 11(a) becomes effective on May 1, 1978, without a clarification or broad exemptive rules, it will cause serious damage to the businesses of the members of our group. I cannot predict that any or all of us will merge or liquidate, but I can tell you that we will be forced to make irreversible business decisions which will weaken our competitive position in both the money management and brokerage businesses relative to the dominant firms in both industries. It is possible that such a result will eventually come about even if H.R. 11140 is enacted, but at least the new leadership at the SEC would have had an opportunity to coordinate implementation of 11(a) with the fundamental changes taking place in our securities markets as we move toward a national market system. We hope that this leadership may be able to devise rules and regulations which will preserve the benefits we offer as independent service-oriented money managers, as well as the liquidity, diversity, and professionalism we bring to the marketplace. These are factors which our clients value and continue to pay for despite the cloud which has hovered over us ever since section 11(a) was enacted.

It would be a disservice for Congress to foreclose the possibility that we could take advantage of new SEC rules by failing to give the SEC more time. It is also possible that the new leadership at the SEC may convince Congress that amendments to section 11(a) are highly desirable. If we are gone by the time those amendments take place, we can't be resurrected. The capital leaves. The people leave. We don't come back. Congress should not eliminate the possibility of considering such an amendment before we have made irreversible business decisions which might negate much of the beneficial effect of such an amendment.

The implementation of 11(a) at this time would further weaken the brokerage community, already torn by prior legislation, negotiated rates, broad economic problems, and an institutional customer base far stronger than the industry. This weakening has manifested itself in the trend toward mergers and in the erosion of the industry's capital base. New capital is already very difficult to attract because the returns don't justify investment. Old capital matures and is withdrawn except in those few cases where the public has provided a more permanent capital. Even here, new capital will be difficult to raise because the great majority of the publicly held brokerage firms are selling well under book value. As each month goes by, capital is paid out, and the problem quietly intensifies. By removing some of us from the scene, this process is accelerated.

In short, this subcommittee is faced with a simple option. Does Congress turn its back and let confusion reign, or does Congress adopt a procedure which permits an orderly, thoughtful resolution of a very complex problem? If I have stated the question in such a way as to leave little doubt about the answer, it is because I believe there is only one rational choice, to enact legislation that the SEC

has proposed and to ensure a comparable extension under ERISA. Thank you.

[Mr. Zicklin's prepared statement follows:]

STATEMENT OF LAWRENCE ZICKLIN, ON BEHALF OF EIGHT NEW YORK STOCK EXCHANGE FIRMS

INTRODUCTION

My name is Lawrence Zicklin, and I want to thank the Subcommittee for this opportunity to testify. I am a partner of Neuberger and Berman and appear here today on behalf of Eight New York Stock Exchange firms with an aggregate of approximately \$3 billion under discretionary money management who share a common interest in maintaining their positions as both money managers and member firm brokers. These firms are: David J. Greene and Co.; First Manhattan Co.; Herzog, Heine & Co., Inc.; Neuberger & Berman; Reich & Tang, Inc.; Stralem & Co., Inc.; and Weiss, Peck & Greer.

We strongly support H.R. 11140, which would delay for eighteen months the effective date of Section 11(a) of the Securities Exchange Act, as amended by the Securities Acts Amendments of 1975. Such a delay is essential to permit further development of the national market system before the Commission acts to adopt appropriate regulations under Section 11(a) and to afford an opportunity for Congressional reevaluation of Section 11(a) in light of the rapidly changing market conditions. Because the market conditions and structure to which Section 11(a) was addressed have changed dramatically, immediate implementation of Section 11(a) would serve no useful purpose and would cause substantial harm.

Before turning specifically to the changes that render Section 11(a) inappropriate today, let me explain the philosophy underlying our position. Our support of H.R. 11140 is based on the premise that it is in the national public interest to have a strong, liquid and highly competitive national marketplace for the securities of public companies. Creation and maintenance of such marketplace depends on three critical factors—(1) elimination of unwarranted barriers to entry into the marketplace; (2) strong competition between participants and among different parts of the marketplace; and (3) evenhanded and, hopefully not overly oppressive, regulation by the Government.

ENFORCEMENT OF SECTION 11(A) IS NOT IN THE PUBLIC INTEREST

Measured against these standards, implementation of Section 11(a) and the comparable restrictions contained in the Employees Retirement Incomes Security Act of 1974 ("ERISA") is not in the public interest.

As you are aware, unless Congress enacts a delay, Section 11(a) would, starting May 1, 1978, prohibit exchange members from executing transactions on national securities exchanges for accounts of non-natural persons over which the member exercises investment discretion. The principle purpose of Section 11(a) was to bar institutions, such as pension plans, mutual funds and insurance companies, from becoming exchange members. This bar on institutional membership was urged on the Congress by some of the less farsighted members of the securities industry to force institutions to continue to execute their securities transactions through unaffiliated member firms. This prohibition was conceived and urged upon the Congress during the transition from fixed commission rates to fully negotiated commission rates when most of the industry had little comprehension of the ultimate impact of that landmark change in our national securities markets.

The economic changes wrought by fully negotiated commission rates have been enormous. Institutions today have as good, if not better, economic access to the floors of the national securities exchanges as the members of those exchanges. For example, the Fidelity group of mutual funds has established arrangements with brokers giving the Fidelity group virtually unrestricted access to the floor of the New York Stock Exchange at a cost less than that available to most non-clearing exchange members. Given the economic realities of today's marketplace, Section 11(a) no longer bars institutional membership in any meaningful way.

We are not critical of these developments; as member firms we are willing to compete with all entities—including banks, insurance companies and others—

who subject themselves to the regulation that attends exchange membership. We only mention these changes to explain why Section 11(a) is no longer needed.

Other industry members and institutions have expressed concern that the mere availability of membership would *force* institutions to join the exchanges whether or not they desire to do so. This argument is based on fixed commission rate precedents in which the Securities and Exchange Commission ("SEC") and the courts expressed concern that some institutions had failed to take advantage of available means to reduce high brokerage costs. In reality, however, the question of exchange membership for an institution is no different than any other decision that the institution makes between internal generation or outside purchase of any product or service it needs. The institution must seek for its beneficiaries the best combination of service and cost. Now that institutions have economic access to the exchanges—at *better* rates than non-clearing members—the legal and fiduciary pressures will be reversed. Institutions will have to justify assuming the regulatory burdens of exchange membership when it provides no additional economic advantage.

Basically, all that Section 11(a) does in the era of fully negotiated commission rates is to bar exchange members from competing with investment advisers, insurance companies, banks and other institutions for discretionary money management business.

Section 11(a)'s arbitrary barrier to competition by exchange members for discretionary money management for non-natural accounts is not in the public interest. If exchange members are barred from providing such services, there will obviously be fewer entities offering money management services and less competition in the provision of such services. Investors will have a narrower choice of professional money managers, the marketplace will have less diversity of investment advice and the cost of discretionary money management will be higher as is typically the case when competition is restricted. Moreover, many small pension plans, funeral trusts, educational endowments and other non-natural accounts will have to employ both an investment manager and a broker when their needs could be more efficiently and economically satisfied by one person or firm.

Unfortunately, the adverse impact of Section 11(a) would not be limited to the market for money management services for non-natural accounts; there would also be an adverse impact in the markets for brokerage services and personal discretionary money management. Here again we must look at the economic effects of fully negotiated commission rates which were not adequately understood when Section 11(a) was enacted. Since the abolition of fixed commission rates, more than 100 brokerage firms—including one of the original members of our group that was forced into a merger—have gone out of business, many through bankruptcy. Moreover, many of the remaining firms, particularly the smaller ones that offer personalized service, have found it more difficult to raise capital and attract business. The result is a more concentrated, less diverse, less liquid marketplace than existed in 1972.

There, nevertheless, remain smaller firms—many of them regional in character—that make a substantial contribution to the intellectual and economic diversity of the marketplace and add depth and liquidity to the national securities markets. Unfortunately, as fully negotiated commission rates continue to make brokerage less profitable and as volatile market conditions make brokerage revenues an unstable source of income, many of these firms will be able to remain viable only because they are diversified into the money management and other activities. Barred from competing for business from nonnatural discretionary accounts, these firms will find it more difficult adequately to serve personal discretionary accounts or even to remain in the brokerage business at all. Any unnecessary bar to diversification can thus only lead to greater concentration of economic power in the hands of a smaller number of entities and to decreased depth and liquidity in the securities markets. We submit that those results would not be in the public interest.

Customers of discretionary money management services—particularly institutions—should be accorded the maximum freedom of choice in selecting money managers. Such freedom of selection, particularly if coupled with wider payment options and greater disclosure concerning costs and performance, will enable customers to select the money managers best suited to their needs. And as the capacity of the market to satisfy the diverse needs of different investors increases, more investors will utilize the markets, adding to their depth, liquidity and strength.

Enforcement of Section 11(a) will also create unequal and unfair governmental regulations. Non-member brokers would not be subject to the Section 11(a) prohibitions because they apply only to exchange members. Thus, enforcement of Section 11(a) would create an irrational incentive for member firms to leave the national securities exchanges—again reducing depth and liquidity—just at a time when Congress and the Commission are trying to strengthen and unify the exchanges with other markets into a comprehensive national market system.

Enforcement of Section 11(a) will also hamper the efforts of many broker-money managers to treat all their customers fairly and equally. For example, a broker-money manager will no longer be able to pro-rate good discretionary purchases equally to all accounts for which such purchases are suitable. If the money manager executed the order, non-natural accounts will be disqualified from the proration.

These examples demonstrate that enforcement of Section 11(a) would be anti-competitive and would create uneven regulatory burdens without benefit to the quality, depth and integrity of our securities markets. Such effects of Section 11(a) may not have been adequately explored when the section was first enacted. In any event, it is anomalous that Section 11(a) runs so directly counter to the repeatedly avowed congressional intent and purpose in enacting the 1975 Amendments of ensuring free access to the instrumentalities of the securities markets and greater competition within and among those markets. The text and legislative history of the Securities Act Amendments of 1975 are replete with evidence that Congress intended to eliminate restrictions on entry to the marketplace and regulatory and self-regulatory rules that impose unwarranted burdens on competition. Indeed, one of the overriding purposes of the Amendments was to assure "full competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets." H. Rep. No. 94-123, 94th Cong., 1st Sess. 47-48 (1975).

ENFORCEMENT OF SECTION 11(A) CANNOT BE JUSTIFIED ON CONFLICT GROUNDS

The only basis now advanced for the enforcement of Section 11(a) is that there are such inherent conflicts of interest in the combination of brokerage and money management that the combination must be prohibited. That rationale for enforcement of Section 11(a) simply does not withstand scrutiny. To begin with, the Congress and the SEC have rarely prohibited relationships which may give rise to potential conflicts of interest but rather have sought to deal with such relationships, particularly in the securities area, through full disclosure and informed consent.

One would suppose that if Congress and the SEC were to deviate from that normal practice, they would do so only in the face of clear and compelling evidence of past abuse. Far from containing any record of abuses, the legislative history of Section 11(a) candidly acknowledges that: "There is no evidence that the conflicts of interest . . . have led to widespread breaches of federal duties." Report of Senate Committee on Banking, Housing and Urban Affairs to accompany S. 249, S. Rep. No. 94-75, 94th Cong., 1st Sess. 65 (1975). And in a recent speech Congressman Eckhard reiterated that "the record failed to reflect any significant abuse" in the combination of brokerage and money management. Moreover, the legislative history also acknowledges that most of the potential for conflicts of interest in the combination of brokerage and money management by exchange members was linked to fixed commission rates and that a competitive rate structure—such as is now in operation—would generally reduce the potential for conflicts of interest. *Id.* at 65-66.

In any event, there are already effective legal prohibitions on most conflict of interest situations. The SEC has repeatedly exercised its enforcement power against money market managers who engage in churning or other improper activities, and investors have private rights of action to redress any abuses.

But even if all of these problems with the conflict argument were set aside, a prohibition on the combination of brokerage and money management only by *exchange members* and only with respect to *non-natural accounts* simply cannot be justified on conflict of interest grounds. There is no rational basis for precluding brokerage and money management by *exchange members* while

permitting *non-member brokers* to engage in such activities. Members are subject to more supervision by reason of their exchange membership than non-member firms and are therefore less likely to engage in abuses.

Even more important, there is no basis for assuming that non-natural accounts—generally institutions, mutual funds, trusts, and pension plans whose directors, trustees or other managers are sophisticated in financial dealings, subject to increasingly stringent fiduciary obligations and advised by a capable array of lawyers, accountants and other specialists—are not completely capable of guarding their beneficiaries from potential conflicts of interest. Such investors are protected against potential conflicts of interest by their enormous economic power, their professional advisors, including professional portfolio evaluation services, and their ability and statistically documented willingness to change money managers whenever it suits their needs.

Although we submit that such an unrealized potential for conflict of interest does not warrant enforcement of Section 11(a) under any circumstances, it seems undeniable that conflict interest considerations cannot justify failure to extend the present May Day deadline for enforcement of Section 11(a). Indeed, as the SEC has pointed out in its submission, enforcement of Section 11(a) under present market conditions might well increase the risk of conflicts in the form of reciprocal practices. And given the number of interrelationships between brokerage firms, such conflicts would be difficult to detect and police.

NO COMMON UNDERSTANDING OF THE REQUIREMENTS OF SECTION 11(A) EXITS

Even if market conditions had not changed since 1975, a delay in the enforcement of Section 11(a) would still be appropriate. No one, including the SEC, understands what Section 11(a) is supposed to mean. As the SEC notes in its memorandum supporting H.R. 11140, the Securities Industry Association and others have changed their positions several times on fundamental questions concerning the desirability and consequences of the Section's implementation, and the SEC itself has been unable to formulate consistent positions when interpreting the Section.

For example, a uniformly accepted meaning for the term "effect" is critical because that definition determines what kinds of activities are covered by Section 11(a). In Securities Exchange Act Release No. 12055 (January 27, 1976), the SEC defined "effect" as meaning not only transactions executed by a member directly on the floor of the exchange but also transactions for covered accounts which the member effects indirectly by referring the transaction for execution by an unaffiliated member. Many commentators, including the SIA, disagreed with the Commission. Then, in Release No. 13388 (March 18, 1977), the SEC proposed an exemption which would permit a member to effect an exchange transaction for a covered account if it retained an unaffiliated member to execute the transaction on the floor of the exchange. The Oversight Report issued in November 1977 by the House Subcommittee on Oversight and Investigations and the Subcommittee on Consumer Protection and Finance rejected both the SEC definition and that advanced by the SIA and adopted yet a third interpretation of the scope of the term "effect."

We hope the Committee will take this confusion into account in measuring what Congressman Eckhardt has described as the "need to maintain the credibility of Congress." While it is true that some securities firms have divested themselves of their money management arms, either in reliance on Section 11(a) or for other business reasons, it is also true that many in the securities industry were slow to understand the import of Section 11(a), that many in the industry failed to perceive its significance in the era of fully negotiated commission rates and that many brokers even today do not understand what full enforcement of Section 11(a) will mean. We, as a group, have repeatedly urged the SEC to adopt clarifying and exemptive rules under Section 11(a) and emphasized the need for adequate lead time to change existing business practices and revise prospectuses. We urge the Congress to take account of the same factors and enact H.R. 11140.

Given these factors, we submit that the credibility of Congress will better be maintained by granting the industry, the Commission and the Congress itself a further period of time to deal with the problems surrounding enforcement of Section 11(a). Such a delay will not cause any substantial damage

to firms that are no longer in the management business; however, failure to grant the delay could narrow competition and increase concentration in this industry, causing damage that will take years to rectify in the event that changes in Section 11(a) are made either by regulation or amendment. In short, the balance of equities—a traditional judicial approach to the grant of a temporary stay—clearly favors an extension of the deadline.

In conclusion, while we would urge the Congress to delay the implementation of Section 11(a), it is obvious from the SEC's and from our standpoint, that the real problem with Section 11(a) is not that it is coming too early but rather that it is coming too late. It was directed at a problem that was cured by other means and a market structure that no longer exists. We believe that when the competitive, regulatory and market aspects of Section 11(a) are fairly weighed, the public interest in a strong national marketplace for securities will eventually dictate outright repeal of that Section.

For the moment, we urge the Congress to postpone its effective date to permit more widespread experience with fully negotiated commission rates and more progress toward a national market system. We are convinced that when the full impact of Section 11(a) on the national securities markets is accurately perceived, neither Congress nor the SEC will want to retain its prohibitions.

Thank you again for this opportunity to speak.

Mr. ECKHARDT. Mr. Garil.

STATEMENT OF BERNARD H. GARIL

Mr. GARIL. I am Bernard H. Garil, vice president of Oppenheimer & Co., Inc., a member firm of the New York, American, Chicago Board Option, and other major securities exchanges. Our firm provides a large array of services to both institutional and individual investors. Through affiliated corporations we manage the portfolios of individuals, registered investment companies, pension funds, and other investors.

This seems to be an annual event for me in that I appeared before your subcommittee and the subcommittee chaired by Congressman John Moss. Last July I jokingly referred to my testimony as an annual event. At that time Congressman Moss made some remark which I thought was in jest, saying he was sure he would see me here next year. Although I am sure his comments were made in jest, they were somewhat prophetic.

I am somewhat disturbed when I look around me at this table today because with the exception of Mr. Roulston, each of us has either appeared on this panel personally or has had other representatives of our firms here. I fear that we may leave with you the misleading impression that our concerns about section 11(a) are limited to a small handful of firms. I can assure you that that is not the case.

As someone who is known to be interested in the 11(a) issue, I often receive phone calls from individuals with firms from throughout our country who are concerned that the implementation of this provision will have profound effect on their firms. In many cases they are afraid that those consequences might be fatal to their organization. Indeed, I have been asked to speak before a number of organizations, member firms, small member firms, other groups which have met to discuss the 11(a) issue and to raise their concerns about it.

I will not deny that 11(a) has a serious impact on our own firm, but as I previously pointed out to this subcommittee, less than 5

percent of our commission income comes from such covered accounts. At the other extreme, for many small firms the income from effecting transactions for such covered accounts as Keogh plans, professional corporations, local hospital trusts, and endowments, accounts for a significantly higher percentage of their income. As has been pointed out, in most of those cases that is their only source of income, from those accounts, who do not receive fees.

You might ask why you the Congress haven't heard from these individuals. For many brokerage firms unfortunately the past few years have been a struggle for survival. Allocating time to work on policy issues or paying an attorney to work for them on these issues is a luxury that many believe they cannot afford. For these reasons they have left it up to the industry organizations to represent them. As you know, unfortunately in the past the industry organizations have been split on this issue. Generally they have been very close. But in the past the SIA and others have generally come out in favor of 11(a). So the slim majority voting in favor of this action has unfortunately left the minority underrepresented.

I am not here today to represent those firms. As I said before, I am here to represent my own firm. Although our firm is affiliated with investment advisers managing large institutional accounts, it is nevertheless sympathetic to the problems of smaller firms. In the past 2 years we have expanded our operation to the point where we are no longer—where the major emphasis of our firm is institutional but more and more of it has become a retail firm.

In the past few years we have opened up offices in Chicago, Los Angeles, and Fort Lauderdale, and we have expanded our retail operation in New York so that a good portion of our operation is that of a smaller firm dealing with the retail customers. At the present time we have more than 200 retail registered representatives, and we have hopes of increasing that by opening up new offices and expanding present offices.

It is the knowledge that we have gained from these endeavors which has shown us the other side of the 11(a) issue, the impact on the retail registered rep, the impact on the retail firm.

I have come today to discuss that, and indeed some of the problems of implementing 11(a) are much simpler when it comes to implementing it with respect to a \$300 million mutual fund, some of which we manage, where the fund is part of a separate management organization, already has a management fee and is clearly under 11(a) and certain other categories that are creating problems for us.

Last year when I testified I suggested that the effective date be put off for 2 years. The documentation behind those recommendations was lengthy. I have a copy of that available for you since the record I believe of that hearing has not yet been published. I won't take time to recite those but I would like to give you some of the examples of some of the problems we have gone through, some of the types of questions which I am sure Mr. Zicklin and his group have asked the Commission.

As he said, many of the questions remain unanswered. Unfortunately, some are answered three or more different ways. We have the old problems. We have the national market system. There is a

recent SEC proposal dealing with referral fees which I don't think a lot of people have even viewed as impacting on 11(a). This may have serious repercussions in that area.

One of the problems is a lack of definition. One example of that is the question of whether or not IRA's, individual retirement accounts, are covered. Obviously, it is an account for a natural person. It is not set up strictly as a trust. There are a number of questions. I have done a great deal of research in this area. We have gone to the SEC and the SIA and asked them to get us an answer. We have spoken with a number of people in our industry. Based on our research, I can assure you that the answer is either definitely yes, definitely no or possibly even maybe. Just total confusion in that particular area.

Similarly floor trading is an area where a natural person would clearly cover it. For reasons of their own the Commission has said that a floor trader is not a natural person, at least with respect to 11(a). I am not here to specifically raise that issue. I am sure the exchanges in their testimony will.

Another example is that with 2 months to go we don't know who is covered and who is not covered.

With the National Market System, here we have an evolving system. One of the things we pointed out to you in the past was that it is possible in many instances to avoid 11(a). 11(a) in many respects was written in a very narrow sense. It spoke about an exchange member executing an order on an exchange of which it was a member.

In the case of our investment companies, the types of orders which are broker dealer executes are large agency crosses where 99 percent of the work is done off of the exchange floor. The function done on the exchange floor is merely the reporting function. If necessary the book is cleared. But the work, the calling of the other side, the attempt to find the other side of that transaction, is all done off the floor of the exchange.

We felt that even with 11(a) it would be possible to continue to do many of those types of transactions merely by taking the order down to an exchange of which we were not a member or, if 390 were eliminated, to do it off of the floor. This is a situation that I don't think has wide application. But in our case it was a possibility.

Now that we go to the National Market System and an order may go down to the Philadelphia Stock Exchange or the Midwest Stock Exchange or some other exchange which we might conceivably leave, we find that the intermarket trading system or whatever system might eventually develop, that an order that goes to one exchange, once it is on the floor might for reasons of execution or the book or whatever the case might be might be transmitted to another exchange, very possibly an exchange of which we are a member. So this flow of orders around the exchanges did not permit those types of things. We have lost control or will lose control in the future of the execution of an order at least with respect to the specific spot at which it is executed. So we have those kinds of problems. Unless one decides to leave all the exchanges, one could not avoid 11(a) through that technique.

Obviously the question which has had the greatest dispute is the meaning of the word "effect." I think Mr. Zicklin referred to some of the kinds of problems there. But I think the Commission in its memorandum said it well when it said:

The substantial public confusion concerning the meaning and application of the section has made it difficult if not impossible for the industry and the self-regulatory organizations to understand what the section means, and therefore to develop plans for adapting their business operations to it, and to anticipate the consequences of its implementation on May 1, 1978.

The definition that the Commission itself has adopted, "effect" basically would be simplified if the broker dealer and the adviser are two separate organizations. They could be affiliated. But, taking our own case, the affiliated money manager is not a member of any exchange. So that if our funds were to place an order with Goldman, Sachs, Solomon Brothers or some other member firm not affiliated with us, the member firm would not be effecting a transaction.

So if we just look at the Commission's definition of the word "effect" then the desire to continue as a money manager purely on a fee basis without receiving any brokerage income, you say, OK, let us separate the two. They will be affiliated. But the money manager will not be a member firm.

On February 2, I believe it was, the SEC came out with a new proposal on referral fees. This has a number of implications. One of the things it does deal with is paying one's own employees for bringing in commission or referring business to your organization.

Where the broker dealer is a different organization from the investment adviser it would be very difficult. You would have to make certain disclosures to your customers. It would be a much more difficult, tedious process for you to compensate your salesmen.

However if the broker dealer and the adviser are one and the same it is relatively simple. You just compensate them as one of your employees. So you are stuck with a quandary. You can either have salesmen get you the business, and once he gets you the business you can't do anything with it because under 11(a) you are prohibited from trading the account or you can trade the account by not having any salesman bringing you business. This is a pending rule. The definition of "effect" is pending. And here we are trying to make decisions with less than 2 months to go.

In my prepared statement I have dealt with some of the other provisions. One solution we have considered is to have dual employees. That might resolve the problem. We have a broker dealer on one hand and an investment adviser on the other hand. Each of our employees would be paid from each of those organizations. The only problem with that, at least from our viewpoint, is that we would have to pay dual social security taxes. The employee would get that back but the employer does not. I don't think the combined rule proposals and definition of "effect" were designed to resolve some of the social security system's problems. But it may end up doing that.

I will try to be brief and just give you examples of the kinds of problems we face in trying to implement this. It is very tough to do any strategic planning for a firm with two months to go when you don't know which way to go.

We need guidance. Once we get that guidance it takes time to implement setting up a separate advisory organization which may be necessary for some firms which requires registration as an investment adviser, setting up new compliance programs. It becomes a difficult task. It is not something you can do overnight.

For that reason we certainly support what the Commission has suggested. We think it is mandatory, if your committee thinks that these many member firms with these problems continue in business, that such legislation be passed and, importantly, be passed promptly because passage of the bill in the waning days of April is going to exacerbate the problems we are all faced with today. Thank you.

[Mr. Garil's prepared statement and attachments follow:]

STATEMENT OF

BERNARD H. GARIL

VICE PRESIDENT

OPPENHEIMER & CO., INC.

BEFORE THE

SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

HOUSE OF REPRESENTATIVES

PROPOSAL TO DELAY EFFECTIVE DATE OF SECTION 11(a)

SECURITIES EXCHANGE ACT OF 1934

MARCH 1, 1978

I am Bernard H. Garil, Vice President of Oppenheimer & Co., Inc., a member firm of the New York, American, Chicago Board Option and other major securities exchanges. Our firm provides a large array of services to both institutional and individual investors. Through affiliated corporations, we manage the portfolios of individuals, registered investment companies, pension funds and other investors.

Once again it is my pleasure to appear before your Subcommittee to discuss Section 11(a) of the 1934 Act. When I appeared before you on this subject last July, I jokingly referred to my testimony as an annual event. At that time Congressman Moss made some comment about looking forward to my appearance at next year's hearings. Although I'm sure his comments were made in jest, they were nevertheless prophetic.

Depth of the Concern

I am somewhat disturbed when I look around me today to see all these familiar faces at this table. With one exception, each of us on this panel have either personally appeared or have had representatives of our firms or groups appear before you in the past. I fear that we leave with you the misleading impression that the concerns about Section 11(a) are limited to a small handful of firms. I can assure you that that is certainly not the case. As someone who is known to be interested in the 11(a) issue, I often receive phone calls from individuals with firms from around the country concerned that the implementation of Section 11(a) poses serious if not fatal consequences for their organizations. Many who were involved in this issue from the beginning thought of it as impacting primarily on those firms such as Oppenheimer which either managed or were affiliated with the managers of large institutional accounts. I will not deny that implementation of 11(a) will have an impact on our firm but as I have previously pointed out to this Subcommittee, less than five percent of

our commission income and a much smaller percentage of our firm's gross income comes from effecting transactions for such account. At the other extreme, for many small firms the income from effecting transactions for such covered accounts as Keogh Plans, professional corporations, local hospital trusts and endowments, accounts for a significantly greater percentage of their income.

You might ask why you the Congress have not heard from these individuals. For many brokerage firms, unfortunately, the past few years have been a struggle for survival. Allocating time to work on policy issues or paying an attorney to work for them on these issues is a luxury they believe they cannot afford. For these reasons they have left it up to the industry organizations to represent them. Unfortunately, in the past the voices of those many firms opposed to 11(a) have not been heard. The industry organizations have been sharply divided on this issue and often a slim majority voting in favor of Section 11(a) set the policy which was espoused to the Congress.

I am not here today to represent those firms whose voices have not been heard, I am here unashamedly to represent the interests of my own firm. Although our firm is affiliated with investment advisers managing large institutional accounts, it is nevertheless sympathetic to the problems of these smaller firms since it has recently expanded its own retail operation. In the past two years we have opened up offices in Chicago, Los Angeles and Ft. Lauderdale in addition to greatly expanding our existing retail operation in New York. At the present time we have more than 200 retail registered representatives with hopes of further increasing that through the expansion of existing offices and the opening of offices in other cities. It is the knowledge gained from these new endeavors which have given us some insight into the plight of those broker-dealers throughout the country who are troubled by the pendency of the Section's effective date.

Need for Postponement

Last year in my testimony at the hearings held before this Subcommittee and the Committee on Oversight I pointed out the confused situation surrounding the implementation of Section 11(a) and suggested that its effective date be put off for two years. Rather than take up your valuable time with a recitation of the reasons stated at that time for that recommendation, I have provided you with copies of that earlier statement.

Last July there remained some chance that between the Congress and the Commission there would be some clarification of the unresolved questions which would have enabled broker-dealers to implement the provision in a timely and orderly manner. Today, unfortunately, we find ourselves in a state of even greater confusion than that which existed last July. Many of the questions about the Section remain unanswered and even worse, in certain instances answered differently by different commentators. In addition, further confusion arises due to the continuing implementation of the National Market System. Other recent developments are continuing to add to the state of confusion. For instance, early last month the SEC proposed a rule under the Investment Advisers Act concerned with the payment of referral fees. As I will explain later, the implementation of 11(a) is significantly impacted by that proposal.

Lack of Definitions

With barely two months to go before the effective date of 11(a), confusion still reigns over whether certain types of accounts are even covered by the Section. In addition, the definition of the key word "effect" as used in the Section has not been cleared up with any degree of certainty. One example of the frustration surrounding the resolution of whether an account is covered or not might be appropriate. For many months we have been attempting to get a definitive answer to the question of whether an

Individual Retirement Account is a covered account for purposes of Section 11(a). We have discussed it with lawyers, people in our industry as well as individuals at the SEC. Based on our research, I can assure that the answer is either definitely yes, definitely no, or possibly even maybe.

Another example of the confusion as to which accounts are or are not covered arose when the SEC stated that individuals who are members of an exchange are not natural persons for the purpose of the Section. Whether or not that is proper interpretation of the Congressional intent will be raised when representatives of the stock exchanges testify. I raise it now merely to show that at this late date one major segment of the exchange community remains in limbo as to its fate with respect to the Section.

Impact of National Market System

The continuing evolution of the national market system has created much additional confusion with respect to 11(a). To give you just one example of this confusion, let me refer back to my testimony of last July. At that time I pointed out that a member of an exchange could potentially avoid the Section by executing orders for covered accounts in the third market or on an exchange on which it is not a member. With the evolution of the National Market System, however, one might not be able to make such a choice. What would happen for instance if a member of the New York Stock Exchange was to send an order to the Philadelphia Stock Exchange, an exchange of which it is not a member, to be executed on that exchange and unbeknownst to the initiating broker-dealer, on the floor of the Philadelphia Stock Exchange it was determined that through the Intermarket Trading System a better execution was available in New York?

The order conceivably could be transmitted from the Philadelphia floor to be executed in New York and the initiating member would inadvertently find itself in violation of Section 11(a).

Many other questions remain unanswered with respect to the impact of the National Market System on Section 11(a). For instance, we will not even know which securities will be eligible for trading in the system until after May. The interaction between exchanges and between the exchanges and the over-the-counter market is still unclear. The specifics of the treatment of limit orders, especially with respect to the determination of where they will be executed, is another uncertainty making implementation of 11(a) difficult.

The question which was the subject of the greatest dispute last July still remains unanswered. I refer to the meaning of the word "effect" as used in the Section. The impact on broker-dealers of the resolution of this cannot be overestimated. The Commission in its memorandum in support of this legislation summed it up well when it said:

"there are now three possible statutory interpretations of the meaning of "effect" and the scope of the Section 11(a) prohibitions.

....

[T]he substantial public confusion concerning the meaning and application of the Section has made it difficult, if not impossible, for the industry and the self-regulatory organizations to understand what the Section means, and, therefore, to develop plans for adapting their business operations to it and to anticipate the consequences of its implementation on May 1, 1978."

Impact of Proposed Referral Fee Rule

Earlier I mentioned that a recently proposed SEC rule dealing with referral fees could also have significant impact on the strategies some broker-dealers have chosen to implement 11(a). One of the more common strategies would have broker-dealers refer covered accounts to an independent investment adviser with the brokerage remaining with the broker-dealer. In its recent release, the Commission said and I quote:

[I]nvestment advisers and broker-dealers have statutory and common law obligations to their clients which may preclude their participating in an arrangement which, among other things, might require an investment adviser to direct a client's transactions to a particular broker-dealer, irrespective of the broker-dealer's ability to execute the transaction competently and at an appropriate cost. Therefore, in certain circumstances, it may be a fraudulent course of business, within the meaning of Section 206(2) of the Act, for an investment adviser to use client commission dollars for this purpose..."

With this strategy potentially foreclosed an alternative strategy would be for the broker-dealer to set up an affiliated adviser which would charge the account an advisory fee. The registered representative currently handling the account would receive his compensation from the fee. The Commission, however, warns that such cash payments to registered representatives may be prohibited. In case they decide not to prohibit such payments they have proposed an alternative rule which would seriously restrict the use of such payments. Although the proposed rule would permit the registered representative to be compensated in cash, it could be done with the fewest complications when the broker-dealer and the registered investment adviser were one and the same. On the other hand, if the adviser is an affiliate of the broker-dealer, the registered representative could not receive his compensation without the need for complying with numerous

and often onerous provisions of the proposed rule. The existence of this proposed rule, at least for purposes of compensating salesmen tends to encourage firms to be duly registered as both broker-dealers and investment advisers. The ultimate definition of the word "effect" in Section 11(a), however, conceivably might have the totally opposite result. For instance, if the Commission's interpretation of "effect" is adopted, an adviser which is also a broker-dealer might find it impossible to place orders for covered accounts even if such orders were placed with unaffiliated broker-dealers. At a time of such confusion, due to disparate SEC proposals what is one to do? Without further consideration one solution might be to have a separate adviser affiliated with the broker-dealer and have the registered representatives on the payroll of both the investment adviser and the broker-dealer. Although such a solution might resolve the securities' law problems it does so only at the cost of creating increased employer costs including a possible doubling of certain Social Security costs. To force firms to incur such additional costs seems to be an unfair and unwarranted burden.

Conclusion

I have tried to be relatively brief today and just give a few examples of some of the problems faced by a broker-dealer in its attempt to do strategic planning where the ground rules have not yet been determined. I am sure that many additional examples could be cited. To avoid this disruption, I ask that you seriously consider the Commission's proposal and that the effective date of Section 11(a) be put off for eighteen months. It must be emphasized that as May is almost upon us there is a need for speedy Congressional action on this proposal.

I thank you for the opportunity to once again appear before you to discuss this important issue and I look forward to answering any questions you might have.

STATEMENT OF

BERNARD H. GARIL

VICE PRESIDENT

OPPENHEIMER & CO., INC.

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

AND THE

SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE

AT JOINT HEARINGS REGARDING SECTION 11(a)

OF THE SECURITIES EXCHANGE ACT OF 1934

July 27, 1977

My name is Bernard H. Garil. I am a Vice President of Oppenheimer & Co., Inc., a member firm of the New York, American, Chicago Board Option and other major securities exchanges. Along with other services, our firm provides research and execution to both institutional and individual investors. Through affiliated corporations, we are responsible for the investment management of more than 1.3 billion dollars in registered investment companies and more than 800 million dollars in assets of pension funds, endowments and other accounts of both institutional and individual investors.

At this time, I would like to submit for the record a letter Oppenheimer & Co., Inc. filed with the S.E.C. earlier this month. That letter, along with the June 1976 letter attached to it, spells out in detail our position on Section 11(a) and the Commission's proposed rules implementing the Section.

The letter of June 1976 traces the history of institutional membership on national securities exchanges and shows that the lack of fully-negotiated rates prior to May 1975 and the lack of any competition in rates in the 1960's provided the major incentive for institutions to seek exchange membership. That letter also analyzes in depth each of the potential conflicts of interest discussed in the 1972 Securities Industry Study. The letter concludes that to date no study by the Congress or the Commission rebuts the findings of the 1971 Institutional Investor Study that...

analyses of regulatory problems resulting from the combination of management and brokerage functions, as well as the accumulation of its experience to date with existing combinations of these functions by members of major exchanges, has not revealed unique, additional regulatory problems whose severity justified sweeping prohibitions of such combinations.

The more recent letter to the Commission is devoted to an analysis of the Commission's proposed rules.

Rather than take the valuable time of the members of these subcommittees to read these letters into the record, I would like to discuss with you an aspect of this issue which I believe has not yet been adequately discussed today.

Chairman Moss, in a speech delivered in 1974, referring to the section that ultimately became Section 11(a), said "I believe that the industry has struck a bad bargain for itself." How right he was!

Section 11(a), I believe, is not necessary to achieve any of the objectives of those who supported it, and it can be shown to have been detrimental to many in our industry. For instance, non-members of exchanges can, even with the existence of 11(a), get most of the benefits of membership, placing in question the value of the section in protecting the economic base of the securities industry. Since May 1975, a large number of member firms of the N.Y.S.E., including many of the major institutionally oriented firms, have either been merged into other firms or have completely ceased operations. All of this has occurred, despite the purported protection provided the industry by the existence of Section 11(a).

The institutions which have been statutorily precluded from joining exchanges and executing orders for affiliated accounts nevertheless have been able to enjoy the major benefit of membership -- low commission rates. We cannot see any other aspects of membership which would make membership desirable to an institution in today's environment. For instance, the value of an exchange logo to an institutional investor is of little, if any, value. An adviser to investment companies will sell no more shares

with an exchange logo nor will an insurance company find its ability to write more insurance enhanced as a member. The right to have one's own man on the exchange floor, a right available only to members, would in most cases prove to be a detriment to an institution rather than a benefit. The arrival of a floor broker at the post with an order to buy or sell a stock would only serve to inform all other participants in the marketplace of the investment intentions of his institution. Obviously, the cost and burdens of exchange regulation are something to be avoided rather than sought.

Some institutions are concerned that the threat of litigation, however, will force them to join exchanges, something they truly believe not to be in their, or their clients, best interests. Throughout the years, the Commission, in several court briefs, and in a 1969 letter on the subject as written by Philip Loomis, then General Counsel, has stated their position in clear terms. In one such brief, the Commission stated:

We are in no way contending that a fund manager has an obligation to join a regional stock exchange or to utilize any specific market in handling any or all portfolio transactions on behalf of its fund. That is a matter of business judgment, to be exercised with a view to the overall best interests of the fund.

Unfortunately, the promulgation of the Commission's recent release and certain language in it has led certain commentators to conclude that the Commission has reversed its position and is now actively encouraging institutions to join an exchange. We do not believe that this is a fair reading of the Commission's release, and we hope that in the future the Commission will make it crystal clear that whatever rules are promulgated, the choice of whether or not one should join an exchange will be

different than any other business decision and is to be made on the basis of economic, and not legal, criteria.

The section, as passed by Congress, is so limited in scope that it also fails to achieve its other purported objective. Existing members of exchanges can, in most instances, easily avoid its restrictions. Even after May 1978, a member of an exchange could continue to execute orders for those non-exempt accounts by executing such orders as agent in the third market or on an exchange on which it is not a member. For instance, our firm, as a major block trading firm, has the opportunity to execute large block transactions for accounts managed by our affiliated advisers. Such orders sometimes are executed as agency crosses where Oppenheimer & Co., Inc., through the use of its upstairs communications network, has been able to find the other side of the transaction. Assuming the elimination of New York Stock Exchange Rule 390 occurs as planned prior to May 1978, agency crosses involving these accounts could be completed without the necessity of going to an exchange, and thus the constraints of Section 11(a) can be totally avoided. Alternatively, the order, even without the promulgation of any rules, can be transmitted to a two-dollar broker on the floor on an exchange of which we are not a member solely for the purpose of completing the transaction and having it reported on the tape.

Since avoidance of the section as passed is so simple, you might ask why we are so concerned about it. There are numerous reasons why we find the section objectionable. Like the previous witness, we believe that this one section of the '75 Act Amendments runs totally contrary to the spirit of those amendments and is anticompetitive in nature.

We also find it very disconcerting that the existence of 11(a) has seriously tainted

the credibility of those investment advisers affiliated with member firms. The legislative history of Section 11(a) and the Commission's attempt in its release to rationalize that history, raises serious, but unjustified, questions about the morality of the combination of brokerage and money management. Although everyone involved in the passage of the section readily refers to it as "the deal" (a clear reference to the securities industry's attempt to protect itself from the economic impact of institutional membership), when it comes to official documentation, the section is most often described as necessary for the prevention of conflicts of interest. Unfortunately, however, the misunderstandings created by this documentation have made those pension fund trustees and others already intimidated by the strict provisions of ERISA and other legislation anxious to avoid any further complications which may occur by choosing an investment adviser affiliated with a member firm. They often choose the "safe" route and quickly eliminate such advisers from consideration.

Of equal concern to firms such as ours is the commonly held misconception that Section 11(a) will ultimately require the complete separation of brokerage and investment management. On those occasions where, for reasons usually unrelated to the section, a broker-dealer has divested itself of an advisory affiliate, the press has been filled with articles about the particular firm having been required to divest itself of its advisory affiliate to comply with Section 11(a). Such misunderstandings have greatly increased the difficulties of getting new business and have added to the competitive disadvantage inflicted upon affiliated advisers by the mere existence of the section.

We are also concerned that Section 11(a) may serve as a precedent for tighter restrictions on all member firm-investment advisory relationships. In the case of investment companies, we have already seen one example of this occurring. Earlier

this year, the Central Securities' Administrators Council proposed an amendment to their statement of policy on open-end investment companies. The proposed amendment, if adopted, will provide that "an investment company shall not effect an/ brokerage transactions in its portfolio with any broker-dealer affiliated directly or indirectly with its adviser or manager." In commenting on their proposal, the Council stated that the proposed determination is "consistent with the intendment of Section 11(a)..."

Although this never was the intention of Section 11(a), actions such as these can readily be expected to arise from the confusion surrounding the adoption of the section. What basically started out as a prohibition on exchange members executing orders for accounts such as investment companies on exchanges on which they are members, may through the enactment of state laws be expanded into an outright prohibition on any trading for such accounts.

The possible extension of the 11(a) prohibitions to transactions for individuals is another cause for concern. The use of 11(a) as a precedent for extending similar prohibitions to the execution of orders for individual investors may at the present time appear remote. We are seriously concerned, however, that once everyone forgets about "the deal", the incongruous fact that 11(a) is supported as necessary to protect sophisticated institutional investors while leaving unprotected individual investors may logically serve as the basis for some future proposal restricting executions for individuals. Indeed the issue has already been raised. In its January 1976 request for responses to a number of questions, the Commission itself asked whether individual investors should be provided with additional safeguards. One commentator, in a preliminary filing with the Commission on the proposed rules, has also raised the question of whether the Commission under 11(a)-2 should "provide similar coverage for the unsophisticated." It should be noted that in a different context

the Commission currently has under consideration a proposed rule which would prohibit off-board dealer transactions with natural persons. In the release proposing the rule, natural persons are described as "those types of customers which the Commission and others fear either lack the sophistication or the market information necessary to enable them to protect their own interests in such transactions." One can only question the logic of having two rules currently pending before the Commission, one of which is based on the premise that when an order is executed as an agency transaction on an exchange, individuals are sophisticated and institutions are unsophisticated and in need of protection, but when that same order is executed by a dealer off an exchange, then the sophisticated suddenly become unsophisticated and in need of protection, and vice versa.

Section 11(a) was passed at a time when few in the securities industry contemplated the eventual impact competitive rates would have on the pricing structure for institutional brokerage services. Many, if not most, of the spokesmen for our industry believed that the greatest threat to its future viability came from the ability of institutions to join securities exchanges and execute their own orders or orders for those accounts which they managed. In an attempt to circumvent that possibility, they actively sought and were successful in obtaining the prohibitions in Section 11(a). In order to do this, it was necessary for them to offer the quid pro quo of restricting their own activities. In 1974, when Congressman Moss issued his warning, few in our industry were ready to agree with him. As May 1978 approaches, more and more of our industry is starting to see how prophetic he was. Unfortunately, undoing the "deal" will not be easy. As we have seen today, institutional opposition to any change is strong. Many institutions believe that 11(a) relieves them of the burden of making the decision whether or not to join an exchange. More importantly, they believe it insulates them from the threat of litigation which has

surrounded this issue in the past.

As is evident from earlier speakers, confusion arises over the extent of the Commission's power to modify the impact of the section. Some commentators have even threatened the Commission with court action if their proposed rules are adopted. Since, as is spelled out in our letter to the Commission, we believe the proposed rules are an inadequate solution, we are seriously concerned that any adequate resolution of the problem could not be reached in time to be implemented prior to May 1978. Indeed, because of the need to renegotiate contracts, rewrite investment company prospectus, etc., any changes in 11(a) would have to be finalized many months before next May. For these reasons we fear that administrative attempts by the Commission to reduce the impact of Section 11(a) may be thwarted merely by the passage of time.

We are also concerned that the problems arising from misunderstandings of what 11(a) was really intended to do will probably not be eliminated solely by action of the Commission. Reluctantly, we are forced to conclude that meaningful relief must ultimately come from the Congress and not the Commission. This is not to preclude any attempt by the Commission to use its exemptive powers in the first instance. Because of the short time constraints involved, we believe the Congress must also start to work immediately towards the goal of a long-term legislative resolution of the problem. Any appropriate resolution should include the removal of any prohibition on any broker-dealer executing orders for accounts over which it or an affiliate has investment discretion.

We are seriously concerned that the Congress would be reluctant to pass any necessary legislation changing 11(a) without further study of the combination of brokerage and money management in the present environment of fully competitive rates and an evolving central market system. Section 11(a) to the extent it was based upon any study of the subject, was

based on an analysis of issues extant in the late 1960's and early 1970's. The changes in the securities markets, the securities industry, institutional investors and the relationships between them have been dramatic since May 1975. Congress may feel compelled to gather more information about these changes before making any decision on Section 11(a). Such further study we fear may not be completed in time for any decisions to be made far enough in advance of next May. Furthermore, completion of any legislation may take even longer. To permit the section to become effective and thereafter to find that it was not needed as a protection of the public interest in the first place, would be grossly unfair to those firms and their clients who would find their relationship inordinately disrupted.

For these reasons, we recommended to the Commission that regardless of what other steps it might take, it seek a postponement of the effective date of Section 11(a) from May 1978 to May 1980. If the Commission has adequate administrative powers to postpone the effective date, we hope it would do so as soon as practicable. If its power to do this is in question, the the Congress, as soon as possible, should seek to put off the effective date until that time when it will be able to fully reconsider the section.

I thank you for your kind invitation to discuss this most important issue with you, and I look forward to answering any questions you might have.

Oppenheimer & Co., Inc.

ONE NEW YORK PLAZA, NEW YORK CITY 10004, (212) 825 4000, CABLE ADDRESS: MOPENER NEW YORK



BERNARD H. GARIL, VICE PRESIDENT

July 14, 1977

Mr. George Fitzsimmons
 Secretary
 Securities and Exchange Commission
 500 North Capital Street
 Washington, D.C. 20549

Reference: S.E.C. File No. 57-613

Dear Mr. Fitzsimmons:

This letter is in response to the request for comments appearing in S.E.C. Release No. 34-13388 of March 18, 1977 entitled Securities Transactions by Members of National Securities Exchanges. It is submitted by Oppenheimer & Co., Inc., a registered broker-dealer and a member of the New York Stock Exchange, the American Stock Exchange, the Chicago Board Options Exchange and other major securities exchanges. Oppenheimer & Co., Inc. provides research, execution and other services to both individuals and institutional investors. In order to facilitate the execution of customer's orders it purchases and sells both listed and unlisted securities for the firm's trading accounts. Oppenheimer & Co., Inc., which is itself registered as an investment adviser, is also affiliated with a number of other registered advisers. Oppenheimer Management Corp. directly manages seven registered open-end managed investment companies and through a wholly-owned subsidiary, Hamilton Management Corp., manages three additional open-end investment companies. Oppenheimer Capital Corp., either directly or through subsidiaries, manages on a discretionary basis approximately \$800 million for individuals and institutional type accounts including corporate pension funds, state and local pension funds, union pension funds and two open-end investment companies. The combined assets of all registered investment companies managed by the advisers affiliated with Oppenheimer & Co., Inc. are approximately \$1.3 billion.

Unlike many broker-dealer affiliated investment advisers, Oppenheimer Management Corp. and Oppenheimer Capital Corp. and their subsidiaries have separate staffs from Oppenheimer & Co., Inc. In making investment decisions their separate research and portfolio management staffs utilize the research capabilities of the major Wall Street firms, as would any adviser not affiliated with a broker-dealer. Likewise their separate trading operations place orders directly with independent broker-dealers. Orders for unlisted securities are normally transmitted directly to market-makers in NASDAQ for execution on a net basis. Similarly, the facilities of the third and fourth market are extensively utilized. With the exception of an overlap in ownership with a member firm, these

advisory operations are almost indistinguishable from those of the so-called "independent investment advisers."

Oppenheimer's Concerns About Section 11(a)

Last year Oppenheimer & Co., Inc., in a letter dated June 14, 1976, responded to the S.E.C.'s request in Release No. 34-12055 to a series of questions on Section 11(a). That letter, a copy of which is attached, spelled out in great detail our belief that implementation of Section 11(a) is neither necessary to discourage institutional membership nor to protect institutional investors from potential conflicts of interest. Since that time, and especially subsequent to the Commission's release of March 18th, there has been much discussion of Section 11(a) as well as much written on the subject. The ideas expressed in our letter of last year are still our beliefs and, if anything, the current debate has only served to strengthen our convictions.

We, like many others in our industry, are deeply concerned about the negative impact 11(a) is already having on the business of those advisers affiliated with exchange members. This impact does not come from any concern with the future implementation of the law, since as will be shown below, the law is easily avoided, but rather from the many misunderstandings about what the law really says. During the past two years we have had many discussions with people in our industry, clients, potential clients and others about Section 11(a). We find it very disconcerting that the existence of 11(a) has seriously tainted the credibility of those investment advisers affiliated with member firms. The legislative history of Section 11(a) and the Commission's attempt in Release No. 34-13388 to rationalize that history, raises serious, but unjustified, questions about the morality of the combination of brokerage and money management. Although everyone involved in the passage of the Section readily refers to it as "the deal" (a clear reference to the securities industry's attempt to protect itself from the economic impact of institutional membership) when it comes to official documentation the Section is most often described as necessary for the prevention of conflicts of interest. Unfortunately, however, the misunderstandings created by this documentation have made those pension fund trustees and others already intimidated by the strict provisions of ERISA and other legislation anxious to avoid any further complications which may occur by choosing an investment adviser affiliated with a member firm. They often choose the "safe" route and quickly eliminate such advisers from consideration.

Of equal concern to firms such as ours is the commonly held misconception that Section 11(a) will ultimately require the complete separation of brokerage and investment management. On those occasions where, for reasons usually unrelated to Section 11(a) a broker-dealer has divested itself of an advisory affiliate, the press has been filled with articles about the particular firm having been required to divest itself of its advisory affiliate to comply with Section 11(a). Such misunderstandings have greatly increased the difficulties of getting new

business and have added to the competitive disadvantage inflicted upon affiliated advisers by the mere existence of the Section.

We are also concerned that Section II(a) may serve as a precedent for tighter restrictions on all member firm-investment advisory relationships. In the case of investment companies we have already seen one example of this occurring. Earlier this year the Central Securities' Administrators Council proposed an amendment to their statement of policy on open-end investment companies. The proposed amendment, if adopted, will provide that "an investment company shall not effect any brokerage transactions in its portfolio with any broker-dealer affiliated directly or indirectly with its adviser or manager." In commenting on their proposal, the Council stated that the proposed determination is "consistent with the intentment of Section II(a)..." Although as stated above this never was the intention of Section II(a), actions such as these can readily be expected to arise from the confusion surrounding the adoption of the section. What basically started out as a prohibition on exchange members executing orders for accounts such as investment companies on exchanges on which they are members, may through the enactment of state laws be expanded into an outright prohibition on any trading for such accounts.

The extension of the II(a) prohibitions to transactions for individuals has already been called for by certain commentators. The possible use of II(a) as a precedent for extending similar prohibitions to the execution of orders for individual investors may at the present time appear remote. We are seriously concerned, however, that once everyone forgets about "the deal", the incongruous fact that II(a) is supported as necessary to protect sophisticated institutional investors while leaving unprotected individual investors may logically serve as the basis for some future proposal restricting executions for individuals. Indeed the question has already been raised. In its January 1976 request for responses to a number of questions the Commission itself asked whether individual investors should be provided with additional safeguards. One commentator, in a preliminary filing with the Commission on the proposed rules, has also raised the question of whether the Commission under II(a)-2 should "provide similar coverage for the unsophisticated."^a It should be noted that in a different context the Commission currently has under consideration proposed rule 15C5-1(a) which would prohibit off-board dealer transactions with natural persons. In the release proposing the rule, natural persons are described as "those types of customers which the Commission and others fear either lack the sophistication or the market information necessary to enable them to protect their own interests in such transactions."^b One can only question the logic of having two rules currently pending before the Commission, one of which is based on the premise that when an order is executed as an agency transaction on an exchange,

^a Letter of Investment Council Association of America, Inc. dated June 6, 1977.

^b Securities Exchange Act Release No. 13662 (June 13, 1977).

individuals are sophisticated and institutions are unsophisticated and in need of protection, but when that same order is executed by a dealer off an exchange, then the sophisticated suddenly become unsophisticated and in need of protection, and vice versa.

Section II(a) Does Not Achieve Any Of Its Purported Objectives

The fact that we are more concerned with the possible use of II(a) as a precedent for more restrictive rules or as a potential for denigrating member affiliated advisers rather than with the law itself is based on our belief that Section II(a) as passed by Congress is so limited in scope that it fails to achieve either of its purported objectives. Existing members of exchanges can in most instances easily avoid its restrictions. Likewise, non-members of exchanges can, even with the existence of II(a), get most, if not all, of the benefits of membership placing in question its value in protecting the economic base of the securities industry. Even after May 1978 an existing member of an exchange could continue to execute orders for those non-exempt accounts by executing such orders as agent in the third market or on an exchange on which it is not a member. For instance, our firm, as a major block trading firm, has the opportunity to execute large block transactions for accounts managed by our affiliated advisers. Such orders sometimes are executed as agency crosses where Oppenheimer & Co., Inc., through the use of its upstairs communications network, has been able to find the other side of the transaction. Assuming the elimination of New York Stock Exchange Rule 390 occurs as planned prior to May 1978, agency crosses involving these accounts could be completed without the necessity of going to an exchange and thus the constraints of Section II(a) can be totally avoided. Alternatively, the order, even without the promulgation of any rules, can be transmitted to a two-dollar broker on the floor of an exchange of which we are not a member solely for the purpose of completing the transaction and having it reported on the tape.

Section II(a) as stated above provides little, if any, protection to the securities industry from the feared economic impact of institutional membership. Since the advent of fully negotiated rates, customers can determine the cost to them of brokerage services by the amount of economic power they are able to, or choose to, exert over the brokerage community. During the past two years we have seen that those institutions which are desirous of minimizing rates have been able to execute their orders at rates equal to or lower than those previously available only to exchange members. In an environment of negotiated rates where price is no longer an incentive to membership, we can see very little that would entice any institution to seek exchange membership. Membership does bring with it certain things unavailable to non-members. For instance, members and only members of an exchange can make use of the exchange's logo. In addition only members are permitted to have one of their own employees on the floor of the exchange. However, in return for these limited benefits, an institution must be willing to subject itself to the high cost and burden of exchange regulation. For several reasons we cannot see how an institution could rationally reach a business decision to do this.

The value of an exchange logo to an institutional investor is of little, if any, value. An adviser to investment companies will sell no more shares with an exchange logo nor will an insurance company find its ability to write more insurance enhanced as a member of an exchange. Having one's own man on the exchange floor would in most cases prove to be a detriment to an institution rather than a benefit. The arrival of a floor broker at the post with an order to buy or sell any stock would only serve to transmit to all other participants in the marketplace the investment intentions of his institution. Obviously with the cost and burdens of exchange regulation as something to be avoided rather than sought, the decision not to join can be easily made. Recognizing this, certain institutions have been examining the possibility of "de facto membership"; that is, having their orders executed using non-affiliated \$2 brokers who would then have the executed orders cleared through firms chosen for that purpose by the institution. All of this would be accomplished at rates similar to those charged to those member firm correspondents which do not have their own men on the floor.

From a pure economic vantage point, it is generally recognized that institutional membership is not a desirable alternative to using non-affiliated brokers and would be avoided by most institutional investors. For instance, at a recent Securities Industry Association Forum on Section 11(a) the former head of an insurance company's recently disbanded brokerage affiliate stated, "I don't see how an institution can justify membership simply to save dollars." Some institutions are concerned that the threat of litigation, however, will force them to do something they truly believe not to be in their or their clients best interests. Throughout the years the Commission, in several court briefs and in a 1969 letter on the subject ^a as written by Philip Loomis, then General Counsel, has stated their position in clear terms. In one such brief the Commission stated:

We are in no way contending that a fund manager has an obligation to join a regional stock exchange or to utilize any specific market in handling any or all portfolio transactions on behalf of its fund. That is a matter of business judgment, to be exercised with a view to the overall best interests of the fund.^b

Unfortunately the promulgation of the Commission's recent release and certain language in it has led certain commentators to conclude that the Commission has reversed its position and is now actively encouraging institutions to join an exchange. We do not believe that this is a fair reading of the Commission's release and we hope that a future release will make it crystal clear that the choice of whether or not one should join an exchange is no different than any other business decision and is to be made on the basis of economic and not legal criteria.

^a Securities Exchange Act Release No. 8746 (November 10, 1969)

^b Memorandum of the Securities and Exchange Commission, objecting to the proposed settlement, p.13, in *Kurach vs. Weissman*, 49 F.R.D. 304 (S.A. N.Y., 1970).

The Proposed Rules

The Securities and Exchange Commission has proposed a series of three rules which, if promulgated, would significantly modify the impact of Section 11(a). Effectiveness of each of the proposed rules is based on a provision which would require any national securities exchange to adopt objective criteria with respect to membership and access to the execution and membership services. Before the operative sections of the rules would become effective, the exchanges would be required to file a plan with the Commission setting forth these criteria and the Commission will then determine whether such a plan eliminates all burdens on competition not reasonably necessary for furtherance of the Securities Act. Although we have no quarrel with the intent of this provision, we find it to be not only unnecessary but also a grant of power to both the exchanges and the Commission which was not contemplated by the Congress when it passed the '75 Act Amendments. This provision, in effect, places those firms relying on some section of the rule to operate in the post May 1978 environment in triple jeopardy. Not only would it be necessary for the Commission to promulgate the operative sections of the rules, but it would also be necessary for the exchanges to adopt yet undefined rules on access and membership and thirdly, for the Commission to find those rules acceptable to it.

If the Commission is concerned that the national securities exchanges have not been revising certain of their rules in an expeditious manner it should attack that problem directly. The Commission should not make the passage of a rule favored by the industry contingent upon the industry's acceptance of another rule which it may deem to be inimical to its interests.

Proposed Rule 11(a) 1-3 Transactions for Accounts Subject to Investment Discretion

Oppenheimer & Co., Inc. strenuously opposes proposed rule 11(a) 1-3 as being neither in the best interests of those investment advisers affiliated with exchange members or more importantly in the interests of the accounts of non-natural persons which they manage. We also fear that adoption of this rule may be potentially more dangerous to the economic well being of the securities industry and the securities markets than the supposed danger of institutional membership which led to the passage of Section 11(a) in the first place. This rule would permit exchange members to execute orders for managed institutional accounts so long as the member does not assess any charge to the account based on transactions effected by or for the account. The rule is not clear as to what type of charges would be permitted. For instance could a fee be based on the turnover in all accounts managed by the advisor? Could a transaction fee be based on NYSE volume during a given period of time? The answers are not clear.

Regardless of what types of fees would be permitted, we as managers of such accounts are concerned that this rule would not in any meaningful way achieve the goal of making 11(a) less restrictive. We believe exchange members would remain and possibly be even less competitive in seeking out accounts if they were restricted with respect to the way they could price their services. The proposed rule, for instance, totally disregards problems arising out of the existence of laws in many states which set maximum expense ratios for investment companies. Presently commissions as capital expenses are not included in the calculation of these maximum expense ratios while fees are included. If non-transaction related charges were to be included in the calculation most member affiliated advisers would be unable to charge an investment company it manages a fee high enough to cover both the cost of managing the account and executing its orders.

Although no such maximums generally exist for pension funds or profit sharing plans, firms which have attempted to sell a non-transaction related fee to such accounts have generally found little receptivity for such a pricing arrangements. This type of fee is often unacceptable to the client especially when the fee is paid by the corporation and the brokerage commissions are paid by the fund itself. The effect of a single fee in this situation would be to shift the cost burden of brokerage to the corporation thus making it very difficult to sell such a pricing arrangement. We also believe that most pension fund trustees would be unwilling to accept a fee schedule which would not be related to their fund's costs and which might involve them in making an estimate of activity in the account prior to accepting the fee. In addition such a fee schedule differs dramatically from those generally offered by most investment advisers. We fear that since the cost of being different in a society as litigious as ours can be very high, trustees may be reluctant to accept anything other than the standard type fee arrangements. For these and other reasons we believe that the relief being offered by the proposed rule is little more than illusory.

Proposed rule 11(a)1-3 would in our opinion also create new potential conflicts to replace those its adoption is purportedly designed to prevent. One such conflict would result from the provision in the proposed rule which under certain circumstances would permit the adviser to use brokers not associated with the adviser even though the adviser has already received a fee which includes brokerage compensation. Presently those investment companies and pension funds managed by our affiliated advisers pay out most commissions to unaffiliated brokers, within the context of best execution, for research and special execution services. Typically, less than a third of their brokerage commissions are paid to Oppenheimer & Co., Inc. In each instance the trader for an account makes a determination where best execution of an order can be achieved in the most expeditious manner. Although his choice of broker may to some extent be influenced by the variety of commission rates available, he is not faced with the problem of choosing an unaffiliated broker only at significant additional cost to the fund.

An adviser charging a non-transaction related fee would have thrust upon it the temptation to execute an even larger percentage of the business with unaffiliated brokers to avoid bearing those costs which would reduce the net income it could expect to earn. Fund directors, pension trustees, etc., on the other hand, would feel obligated to question any trade done with anyone other than the affiliated broker, since such trades would create additional expense for the account. Additionally, many have argued that with the adoption of a non-transaction related fee there would be created an incentive to reduce turnover.

We do not believe that the creation of these new potential conflicts would result in any serious problems. Just as we do not believe that the present system has resulted in any abuses arising from existing potential conflicts, we cannot see why any new potential conflicts would result in abuses. It seems to us however that little in the way of investor protection would be accomplished by the substitution of one group of potential conflicts with another.

If we are wrong in our belief that a non-transaction related fee is generally unacceptable to our institutional type customers nevertheless the proposed rule is troublesome. States may change their laws and permit increases to allow such a fee for mutual funds and pension fund trustees may to our surprise accept such a pricing structure when it is offered to them by broker-dealer affiliated advisers. If this were to be the case, such schedules might be more widely adopted by investment advisers, including those not affiliated with broker-dealers, for competitive reasons. Adoption of such a fee schedule by these non-affiliated advisers would result in a dramatic shift in the existing economic relationship between broker-dealers and institutions. Aside from legal and some competitive pressures, institutions currently have a powerful incentive to maximize rather than minimize commission rates. This is true because it is generally the client of the institution which pays the commission while the institution gains for itself many of the benefits such as the research and other services paid for by those commissions. Indeed the Congress itself recognized and sanctioned this system with the passage of Section 28 (e) in 1975. With the adoption of a non-transaction related fee, however, the non broker-dealer related institution itself, as opposed to its client, becomes the customer of the brokerage community. With such a change the incentive would be for the institution to then attempt to minimize commissions, since every penny saved by it in commissions would result in a direct increase in the institution's profitability.

The pressure to minimize commissions could eventually result in their total elimination. This would occur when institutions would, wherever possible, deal on a net basis. Such dealings could occur in the third market or, if and when rule 390 is eliminated, with member firms themselves. This would only hasten the elimination of the agency market as we know it today, to be replaced by a dealer market possibly similar to that which presently exists for over-the-counter securities. We do not believe the use of 11(a) in encouraging this is in the best interests of the investing public.

We are also concerned that proposed Rule 11(a) 3 does not distinguish between discretionary accounts for natural persons and others. Unlike Section 11(a) itself, the proposed rule appears to be much more farreaching in that it has the effect of eliminating the exemption for natural persons in the legislation. We have been led to believe that this was an inadvertence. If it was inadvertent we believe a clarification is in order.

Proposed Rule 11 (a) 2-1 Transactions for the Accounts of a Member

Proposed rule 11(a) 2-1 would require member's orders to yield priority in execution to orders at the same price for the account of non-members. With the exception of orders for the account of odd-lot dealers the proposed rule would impose the priority requirement upon several classes of transactions even though the Congress chose to exempt such transactions from restrictions when Section 11 (a) was passed. Although we believe the imposition of rules such as this on those accounts of members which do not perform a clearly beneficial service to the marketplace may be warranted, we are seriously concerned with the imposition of such rules on those transactions involving market-making, arbitrage, block positioning, etc. The Commission has in the past done much to encourage competition among market-makers. Adoption of this rule we believe would have the opposite effect.

Block positioning for instance would be impacted in such a negative way as to potentially discourage a member from purchasing that portion of a customer's order which it is unable to place with other institutional or retail customers or which cannot be readily sold in the market. The imposition of a priority rule would generally require a member to give up stock at current prices to other persons in the marketplace. Since customer positions are generally reluctantly acquired, positioners normally would not object to having their risk reduced by the insertion of a public purchaser in lieu of themselves. It is the liquidation of acquired positions, however, which could be severely hampered if members were forced to yield priority to the accounts of non-members. They would often find themselves placed in the position of being forced to liquidate positions at lower prices in order to avoid those non-members having priority over themselves. This would be so even even though those non-members' orders entered the marketplace at a much later time than theirs. Infringement on a positioner's ability to liquidate positions in a timely manner, except at the cost of suffering a price detriment, could only result in a reduction of desire to acquire those positions in the first place. Although the above example deals with block transactions it holds equally true for most market-making and arbitrage activities of member firms.

For this reason we believe the Commission should not adopt proposed rule 11 (a) 2-1 as written. Exemptions for accounts such as market making, arbitrage, etc. should be included along with the one proposed for odd-lot dealers if such worthwhile activities are not to be discouraged.

Proposed Rule 11a2-2 Members Transaction Effected Through Other Members

To the best of our knowledge Section 11(a) was not intended to require exchange members to divest themselves of their money management affiliates. The ability of an investment advisor affiliated with a member firm to place orders on behalf of its managed accounts with an unaffiliated member firm was always considered permissible even after May 1978. If it were not to be permitted the result would then be the complete separation of the functions. Although this result was never even contemplated by the Congress, some commentators argue that this may have been the intent of the Congress merely because of ill-chosen language. It will probably now be necessary for a rule to be promulgated by the Commission clarifying the situation. The operative portion of proposed Rule 11a2-2 should achieve that result. Unfortunately, like the others, proposed Rule 11a2-2 would not become operable until plans are adopted by exchanges and approved by the Commission setting forth the criteria for membership and access. To potentially deprive accounts managed by members or their affiliates of the opportunity of having their investment decisions implemented on an exchange even by unaffiliated members unless such plans are approved would place those accounts at an unconscionable disadvantage. For this reason we believe the rule should be adopted with the deletion of Section 11a2-2(b) and all references to it.

The rule as proposed is not explicit enough on the question of handling covered transactions. Specifically, it is unclear to what extent a member can participate in a transaction for that account. Clearly such a broker cannot execute the order nor can the order be communicated to the broker at his booth on the floor. We assume, however, that a broker can attempt to find the other side of such transaction using its own upstairs facilities and then transmit the order to an independent broker on the floor to be exposed to the crowd at the post and printed. Likewise, we assume that the affiliated broker-dealer would be permitted to confirm and settle a transaction which has been executed by a broker not associated with the member. Naturally, the affiliated broker-dealer should be entitled to receive compensation to the extent of his participation in the transaction.

Conclusions and Recommendations

Section 11(a) was passed at a time when few in the securities industry contemplated the eventual impact competitive rates would have on the pricing structure for institutional brokerage services. Many, if not most, of the spokesmen for our industry believed that the greatest threat to its future viability came from the ability of institutions to join securities exchanges and execute their own orders or orders for those accounts which they managed. In an attempt to circumvent that possibility actively sought and were successful in obtaining the prohibitions in Section 11(a). In order to do this it was necessary for them to offer the quid pro quo of restricting their own activities. Congressman John Moss, then Chairman of the Subcommittee on Commerce and Finance of the House of Representatives'

Committee on Interstate and Foreign Commerce said in a reference to what ultimately became Section 11(a), "I believe the industry has struck a bad bargain for itself."^a As May 1978 approaches, more and more of our industry is starting to see how right he was. Unfortunately, undoing the "deal" will not be easy. Institutional opposition to any change is strong. Many institutions believe that 11(a) relieves them of the burden of making the decision whether or not to join an exchange. More importantly, they believe it insulates them from the threat of litigation which has surrounded this issue in the past.

For many institutions the Commission's release has rekindled the fear of future litigation. We believe these fears are unjustified but nevertheless it appears that until the cases in the courts have run their course confusion will continue to reign.

Further confusion arises over the extent of the Commission's power to modify the impact of the Section. Some commentators have threatened the Commission with court action if the proposed rules are adopted. Since we believe the proposed rules are an inadequate solution, we are seriously concerned that any reasonable resolution of the problem could not be reached in time to be implemented prior to May 1978. Indeed, because of the need to renegotiate contracts, rewrite investment company prospectuses, etc.; any changes in 11(a) would have to be finalized many months before next May. For these reasons we fear that administrative attempts by the Commission to reduce the impact of Section 11(a) may be thwarted merely by the passage of time. We are also concerned that the problems arising from misunderstandings of what 11(a) was really intended to do will probably not be fully eliminated solely by action of the Commission. Reluctantly we are forced to conclude that meaningful relief must ultimately come from the Congress and not the Commission. This is not to preclude any attempt by the Commission to use its exemptive powers in the first instance. Because of the short time constraints involved, we believe the Commission must also start to work immediately with the Congress towards the goal of a long-term legislative resolution of the problem. Any appropriate resolution should include the removal of any prohibition on broker-dealers executing orders for accounts over which they have investment discretion. If necessary, the Commission should be given whatever additional power it may currently lack to see that any potential conflicts arising out of particular arrangements combining brokerage and money management are adequately disclosed. Such powers, however, should be limited to disclosures about the details of particular arrangements and should not serve as the rationale for the use of "boiler plate" warnings against the combination of brokerage and money management in general.

We are seriously concerned that the passage of any necessary legislation could not be accomplished without further study of the problems or potential problems arising from the combination of brokerage and money management in the present environment of fully

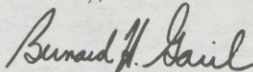
^a Speech before a Conference for Senior Management, New York, N. Y., January 18, 1974.

competitive rates and an evolving central market system. Section II(a) to the extent it was based upon any study of the subject, was based on an analysis of issues extant in the late 1960's and early 1970's. The changes in the securities industry, institutional investors, and the relationship between them have been dramatic since May 1975. In addition, the central market system in which they operate has not been fully designed. If Congress needs more information about these changes before making any decision on Section II(a) we can see the need for additional study. However, such further study may not realistically be completed in time for any decisions to be made far enough in advance of next May. Furthermore, completion of any legislation which may be introduced as a result of a study will take even longer. To permit the Section to become effective and thereafter to find that it was not needed as a protection of the public interest in the first place would be grossly unfair to those firms and their clients who would find their relationship inordinately disrupted.

For these reasons we recommend that the Commission, regardless of what other steps it might take, seek a postponement of the effective date of Section II(a) from May 1978 to May 1980. If the Commission, after consultation with the appropriate members of the Congress, believes it has adequate administrative powers to postpone the effective date it should do so as soon as practicable. If it does not believe it clearly has such power it should immediately seek a legislative postponement.

Thank you very much for the opportunity to comment on the proposed rules. If the Commission or its staff has any further questions on this submission, we would be most happy to respond to them. Should the Commission decide to hold hearings on Section II(a) or the proposed rules, we would appreciate the opportunity to present our arguments at that time.

Sincerely,


Bernard H. Garil

BHG:jd1

Oppenheimer & Co., Inc.

ONE NEW YORK PLAZA, NEW YORK CITY 10004, (212) 825 4000, CABLE ADDRESS: MOPENER NEW YORK



June 14, 1976

Mr. George A. Fitzsimmons
Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

Dear Mr. Fitzsimmons:

This letter is in response to the SEC's request in Securities Exchange Act Release No. 12055 for answers to a series of questions on Section 11(a) of that Act. This response is submitted by Oppenheimer & Co., Inc., a registered broker-dealer and a member of the New York Stock Exchange, American Stock Exchange and other major stock exchanges. It provides research, execution and other services to both individual and institutional investors. Oppenheimer & Co., Inc. is affiliated with a number of registered investment advisers. Oppenheimer Management Corp. is a registered investment adviser which directly manages six registered open-end managed investment companies and through a wholly-owned subsidiary, Hamilton Management Corp., manages three additional open-end managed investment companies. The combined assets of all registered investment companies managed by Oppenheimer Management Corp. and its subsidiaries are approximately \$1.4 billion. Oppenheimer Capital Corp., either directly or through subsidiaries, manages on a discretionary basis approximately \$750 million of assets for individuals, corporate pension funds, state and local pension funds, union pension funds and other entities. In addition, for accounts with many more hundreds of millions of dollars it acts as an adviser on a non-discretionary basis.

Background of Section 11(a)

Section 11(a) was added to the Securities Exchange Act of 1934 upon passage of the Securities Acts Amendment of 1975. The Section was the result of a great deal of discussion and compromise and the final product reflected the concern of many in the securities industry that institutional

membership on national securities exchanges could only be prevented by prohibiting those brokerage firms which managed institutional type accounts from executing orders for these accounts. Although the potential conflicts of interest involved when broker-dealers can execute orders for such accounts was discussed at length, one can readily conclude that conflict of interest was more of a rationalization for the Section rather than its *raison d'être*. In our comments we hope to show that the sweeping prohibitions in Section 11(a) cannot be justified on the basis of preventing conflicts and, more importantly, that competitive rates have negated the securities industry's arguments on the institutional membership issue.

Potential Conflicts of Interest

Although, as stated above, we believe the economic question raised by this issue are the key ones, the conflict questions raised before the Congress should not remain unanswered. The two Congressional studies^{1]} which served as the basis for much of the Securities Acts Amendments based the need for a ban on the execution of orders for affiliated accounts on the potential conflict of interest which exists when the brokerage and money management functions are combined. Among the potential problems raised in those studies were churning, discriminating among accounts, bias in the choice of markets, reciprocity, the negotiation of commissions at other than arms length, and the dumping of principal positions in managed accounts. With the exception of the latter two, all of the potential conflicts are ones which also occur independent of the combination of brokerage and money management. For instance, on the subject of churning the 1963 Special Study of the Securities Markets points out that the

- 1] Securities Industry Study, Report of the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, U. S. Senate, February 1973, pp. 75-77.

Securities Industry Study, Report of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives. August 1972, pp. 148-149.

"granting of investment discretion is not a necessary prerequisite to churning."^{1]} The studies fail to cite any evidence that churning is a serious problem. The SEC's report "Public Policy Implications of Investment Company Growth" reported in its own findings as well as commenting on the findings of the previous Wharton School study as follows:

"The Wharton Report found that - there was no close relationship between broker affiliation and fund turnover rates. The Commission staff reached similar conclusions when it studied portfolio turnover rates of 109 funds."^{2]}

The Institutional Investor Study which is cited in the studies found that "All other factors being the same, a broker-dealer affiliated advised account will have a 1.7 percentage point higher turnover rate."^{3]} Certainly a difference so miniscule could not have been used as a justification for so sweeping a legislative prohibition.

It should also be pointed out that churning is currently illegal and was illegal prior to the passage of this legislation. It would appear from the lack of any evidence of churning of managed accounts and the existence of rules which currently prohibit it, that 11(a) was an unnecessary addition to the protections already in place in this area.

The studies cite as another problem arising from the combination of brokerage and money management the potential for an adviser to discriminate among its customers. Such potential exists when broker-dealers

1] Special Study of the Securities Markets of the SEC, 1963, Pt 1, pp. 297-298.

2] Public Policy Implications of Investment Company Growth 1966, p. 189.

3] Institutional Investor Study Report of the SEC. 1971. Pt. 2, p. 1973.

are advising customers on a non-discretionary basis as well as when investment advisers which are not affiliated with broker-dealers render advice to more than one customer. Thus, even if brokerage and money management were completely separated, a more far-reaching change than that required by Section 11(a), this potential problem would not be affected in the least.

The studies also state that broker-dealer affiliated money managers may fail to obtain best execution for their managed accounts in order to favor their own pecuniary interests in obtaining commissions through reciprocal arrangements. To the extent that this is a problem and no evidence of one has been shown, Section 11(a) does not resolve it but exacerbates it. Until May 1978 most broker-dealers will be able to execute orders for their affiliated accounts and receive the commissions on those transactions. When executions for certain of these accounts are prohibited, however, it is only logical that broker-dealers might seek other arrangements in order to make up for the loss of direct commission income.

The studies also cite as another potential conflict the problem of determining the appropriate commission to be charged in a negotiated transaction with an affiliated account. Although the lack of arms-length bargaining could result in a disadvantage to the affiliated account, our experience has shown that it has had the opposite effect. Regulation of this conflict has actually resulted in lower charges to these affiliated accounts. Affiliated accounts generally receive most favored treatment under guidelines established by the Commission. In May 1972, the SEC said that commissions on transactions executed for affiliated accounts are held to a double standard. In its release the Commission stated:

Applying the proper standard would mean, with respect to any transaction to which competitively determined rates are applicable, that the execution should not be placed with the affiliated broker at a commission rate less favorable than the broker's contemporaneous charges for its other most favored, but unaffiliated, customers.

In addition, in determining to place an order with such a broker, the adviser must make the good faith judgment that such broker is qualified to obtain the best price on the particular transaction and that the commission in respect of such transaction is at least as favorable to the company as that charged by other qualified brokers.^{1]}

Naturally, these guidelines are applicable only when an affiliated broker-dealer executes the orders. These guidelines are not applicable to non-affiliated broker-dealers and the commissions charged on orders executed with them would generally be significantly higher. Because of this any prohibition on executing orders for affiliated accounts could result in increased commission costs for those accounts managed by broker-dealer affiliated advisers.

Although there are many potential conflicts cited by the studies, in our opinion, only one was significant enough to require legislation. It is the potential for broker-dealers to use managed accounts as a vehicle to dispose of undesirable positions which the broker-dealer has acquired for its own account. The banning of such transactions existed in three areas even prior to the 1975 Act Amendments. Section 17 of the Investment Company Act of 1940 prohibits principal transactions between investment company advisers or their affiliates and the investment companies they advise. The Employees Retirement Income Security Act similarly prohibits pension fund advisers from dealing as principal with the funds they manage. Finally, the Glass-Steagall Act prohibits banks from acting as dealers in other than certain exempt securities.

Since Congress chose to exempt the accounts of individuals from the restrictions, one can only infer that the prevention of potential conflicts of interest was not the reason for the Section. It is unlikely that the Congress could have reached the conclusion that individuals were more sophisticated nor could they have concluded that individuals were already provided greater protection than institutional investors. Any

1] Securities Act Release No. 5250, May 9, 1972.

analysis of the built-in protection mechanisms afforded one major type of institutional accounts will show that this is certainly not the case.

Possible problems arising from conflicts are, in the case of registered investment companies, minimized by the comprehensive regulatory and disclosure provisions of the Investment Company Act. Among other things that Act requires that a fund which uses an affiliated broker as its regular broker have a Board of Directors made up of a majority of unaffiliated directors. Over the years the role of the unaffiliated director has become more and more important. At this time these directors generally provide real protection for the interests of the shareholders they represent. Further protections are afforded by prospectuses and proxy statements which spell out to the potential investor, as well as those who have already invested, the areas of potential conflicts. Rates of turnover, brokerage policy as well as the amount of brokerage commissions paid to affiliated broker-dealers, as well as others, are spelled out in detail. Additional filings with the Commission, such as the N-1R give even more detail and are available to those investors desirous of obtaining them. In addition to the SEC, the state securities administrators, and members of the private bar are carefully scrutinizing the activities of advisers to assure that any potential conflicts do not become actual conflicts. In short, we submit that adequate safeguards against conflicts of interest already exist and that experience has demonstrated that they are effective.

Since the passage of ERISA most pension funds are also now subject to comprehensive regulatory and disclosure protections. In addition, trustees or others responsible for the choice of advisers, often with the help of sophisticated consultants, constantly monitor the activity of the pension fund's advisers. This often results in a fund's adviser being replaced. In one instance earlier this year a major state pension fund was taken away from a broker-dealer affiliated adviser because of concern over a controversial transaction. Interestingly enough the state named another broker-dealer affiliated adviser to manage the account. Obviously, in the eyes

of the administrators of that fund the controversial transaction entered into by the first adviser was not symptomatic of a problem broad enough to require the avoidance on their part of any further relationship with broker-dealer affiliates.

The SEC, the agency most familiar with broker-dealers, has questioned the need for this Section. Throughout the years it neither sought nor favored these sweeping legislative changes. Its 1971 letter transmitting the Institutional Investor Study to the Congress stated:

[T]he Commission believes that the Study's admittedly limited analyses of regulatory problems resulting from the combination of management and brokerage functions, as well as the accumulation of its experience to date with existing combinations of these functions by members of major exchanges, has not revealed unique, additional regulatory problems whose severity justified sweeping prohibitions of such combinations.

No additional investigation or study since that time by the Congress or others has turned up any additional factual information which could lead to any other conclusion.

Institutional Membership

Many in the securities industry are concerned that without 11(a) institutions will either voluntarily or through threat of litigation seek to avoid dealing with brokers by joining an exchange. We do not believe that those concerns are justified. To understand why there is little incentive for institutions to seek exchange membership now or in the future one must look to the reasons why institutions sought membership in the first place. Originally, exchange membership was sought by those institutions such as insurance companies and mutual funds with captive sales organizations

which believed that commission rates were too high and which couldn't find an alternative use for those commissions. They used their memberships on regional exchanges as a means of reducing those commissions. A number of other institutional investors, either in settlement of legal suits or to prevent such suits, have felt compelled to join an exchange in order to reduce the commissions they paid. In those instances institutional membership was symptomatic of a commission rate structure which failed to recognize any of the economies of handling large institutional orders.

Since the advent of competitive rates, the cost to an institution of having its orders executed is determined not by its status as an exchange member or non-member but rather by its willingness to use its economic power to have its orders executed at the lowest price. For instance, many of the largest banks and other institutions in the country have exerted enough economic power to have their orders executed on the floor at a lower rate than that which is charged to a small member firm by its correspondent. Each day one hears about various deals institutions have with member firms to have their orders executed at rates of 10 to 15 cents a share or even lower. If an institution without membership can do trades at rates which at least on small orders may be equal to rates discounted 80 percent or more from the fixed rate in effect prior to May 1975, why should it seek membership with all of the costs and regulatory burdens that membership entails?

Since membership is no longer needed to achieve the economic benefits previously available only to members, the Congress itself has found it necessary to amend the law to provide for a new definition of "member." Prior to passage of the Amendments a member was defined as one who received those benefits which most institutions sought, namely, the ability "to make use of the facilities of an exchange for transactions thereon without payment of a commission or fee which is less than that charged the general public."^{1]}

1] Securities Exchange Act. Sec. 3(a)(3) subsequently amended.

A "member" is now defined as one who can effect transactions on the floor of the exchange without the services of another person acting as broker. This form of membership, i.e., access to the floor of an exchange is something few institutions have sought. Indeed, even where pressure through litigation or otherwise was placed on institutions to join an exchange, access to the floor was not the reason for that pressure. Access to the floor for most institutions would probably be detrimental since the arrival of an institution's broker at a particular post on the floor could telegraph to all of the members the investment intent of his institution.

Some argue that as long as rates remain above zero there will continue to be legal pressure on institutions to join an exchange. Thus, 11(a) is needed to prevent these pressures. We believe this argument to be of dubious merit. Even under fixed rates the pressure to join an exchange was limited. The Commission, for instance, has argued on numerous occasions that mutual fund managers did not have any legal obligation to join an exchange. That decision was simply one of business judgment. It is no different than making any other "make or buy" decision. Certainly, since the advent of fully competitive rates the decision to "buy" is easily arrived at and difficult, if not impossible, to question. Moreover, the Congress itself in Section 28(e) has made it clear that no institution has any obligation to seek the lowest rate of commission. Most assuredly, if one can pay a higher commission, then one can pay a commission in the first place.

A second type of institutional investor has sought membership because it has found that the management of money of and by itself has not enabled it to earn an adequate profit, if any profit at all. We have always believed that this problem should be solved directly by permitting institutional investors to set their fees at a level which would enable them to manage money profitably without having to resort to discovering new sources of operating profits elsewhere. In the past some exchange member firms may have in a small way been indirectly responsible for keeping fees uneconomically low. Through the use of commission offsets

some member firms have charged unrealistically low management fees which, in turn, may have caused those institutional investors not affiliated with broker-dealers to charge fees which were too low to sustain their operations on an independent basis. Competitive rates have greatly reduced whatever competitive advantage these member firms may have enjoyed and will consequently reduce the need for others to join to counteract that advantage.

Another new form of fee arrangement has been gaining in popularity lately among broker-dealer affiliated advisers. The single charge which covers both management and brokerage undoubtedly has many advantages. It removes from the broker-affiliated adviser the problem of negotiating a rate on individual transactions. In addition, it eliminates from the mind of the regulator any questions of churning, only to replace it, however, with the question of whether any reduction in activity was to reduce costs. For the customer it effectively changes a capital expense, commissions, to an ordinary expense, fee. Widespread adoption of the single charge by other types of institutional investors could present a potential future problem for the securities industry. It might dramatically alter the relationship between broker-dealers and those institutions. Under a single fee arrangement commission savings would enhance the bottom line of the institution. Conceivably profit pressures placed on portfolio managers and traders from above could ultimately be reflected in further pressure on rates with a resultant reduction in commissions flowing to the brokerage community.

Other institutional investors have sought membership not for the purpose of recapturing commission for themselves but rather, directly or through affiliates or subsidiaries, to perform a public brokerage function. With competitive rates membership on an exchange is no longer a prerequisite for performing a public brokerage function. Indeed, many commentators on our industry have expressed concern that existing members may seek to leave the exchange to avoid some of the burdens placed upon

members. Others who are now entering the business are doing so by taking advantage of the low rates available to non-members. In addition, it has been reported that at least one bank is setting up a retail brokerage operation and will clear its transactions through a member firm. Many in our industry are terribly concerned about this development. Significantly this potentially great inroad into the securities industry by banks and possibly other institutions is in no way impeded by Section 11(a).

Conclusions

One can only conclude from the above that the provisions of 11(a) which restrict the ability of members to execute orders for certain affiliated accounts are no longer needed to insulate the securities industry from any potential harm arising from the remote possibility that institutions will seek exchange memberships. The broad sweep of the Section could not in the past, nor can it now, be justified on the need to prevent conflicts of interest.

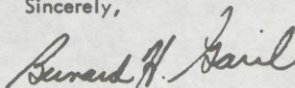
Section 11(a) has had the greatest economic impact not upon institutional investors but upon those broker-dealers who currently or in the future might execute orders for those accounts with which they are affiliated. For many of them it has meant eliminating investment advisory services to these accounts as part of their product mix. For many others their ability to attract additional accounts have been severely hampered by the taint cast upon them by the legislation. To the extent that the '75 Act Amendments had as a major goal an increase in competition, 11(a) has been and will continue to be counterproductive.

Recommendation

The Commission should as promptly as possible take whatever steps are necessary to modify the impact of those provisions. To the extent the Commission believes that the broad exemptive powers it has in 11(a)(1)(H) can be used to exempt additional types of accounts, including registered investment companies, pension funds and similar institutional type accounts, it should be used.

If these powers prove to be inadequate, the Commission should as soon as practicable seek legislation to amend the Section. In addition, the Commission should seek to work along with the Department of Labor and Treasury to modify either through exemption or legislation those sections of ERISA which limit the ability of broker-dealers to execute agency orders for pension accounts managed by affiliated investment advisers.

Sincerely,

A handwritten signature in dark ink, appearing to read "Bernard H. Garil". The signature is fluid and cursive, with the first name "Bernard" and last name "Garil" being more prominent than the middle initial "H".

Bernard H. Garil
Vice President

BHG/dc

Mr. ECKHARDT. Mr. Nelson.

Mr. NELSON. I request that my statement be included in the record I would just like to deal with certain aspects.

Mr. ECKHARDT. Without objection it will be so ordered.

STATEMENT OF STUART K. NELSON

Mr. NELSON. My name is Stuart Nelson. I am managing director and general counsel of Sanford C. Bernstein & Company, Inc., a member firm of the New York Stock Exchange and a registered investment adviser. On behalf of my firm I wish to express my appreciation for the opportunity to testify before this committee.

We wish to join with the Securities and Exchange Commission and the Securities Industry Association in recommending an 18-months' deferral. We also request the committee in its report deal with the concurrent 18-months' deferral necessary for purposes of the Employee Retirement Income Security Act of 1974.

If this deferral is not approved by Congress then we believe the legislators and regulators should address themselves to the following issues.

In its report dated November 15, 1977, the Joint Committee of the Subcommittee on Consumer Protection and Finance and the Subcommittee on Oversight and Investigations stated that—

A primary purpose of Section 11(a) was to place broker-dealers with managed accounts [of nonnatural persons] on the same footing as their competitors, such as bank trust departments and investment counsel organizations. Those account managers which are not brokers do arrange for others to execute transactions for accounts [of nonnatural persons] under their management. Accordingly, account managers which are brokers should be able to engage in similar activities. Furthermore, the stable revenue source which the money management business affords brokers has always been recognized as desirable and in the public interest, for it helps to dampen the fluctuations in revenues to which brokers are typically subject.

The committee agreed that it was permissible under section 11(a) for an exchange member to arrange for another member to execute transactions which the first member orders on behalf of an account of a nonnatural person under its management. However the committee expressed the view that it would be "clearly unlawful" under section 11(a) for the broker with the managed account to retain any compensation for making such arrangements.

The Commission in its statement earlier today interprets the committee position as follows: The Commission is concerned that many in the securities industry for example may be unaware of the subcommittee's recent statement to the effect that the section makes it clearly unlawful for member firms to retain transaction-based income for participating in any way in effecting trades for managed accounts.

I would suggest the Commission should reconsider their statement as to this aspect in view of the original Oversight Committee report and also in view of the following reasons.

One, there is no restriction in legislation or rules that I know of that an investment adviser, should it so desire, might not charge an advisory fee based upon the number of transactions or the dollar value of transactions.

Second, we assume that the congressional committee in making the original determinations considered the following. "Customary brokerage" is divided into four separate functions: "upstairs" trading; floor execution; floor comparison and purchase and sale comparison; and clearance (including cage, dividend and stock record, and margin).

With the exception only of floor execution, each of these functions may be, and in fact often are, performed by bank trust departments and investment counsel organizations. Major banks and investment counsel organizations have trading departments and have clearance departments.

The only function that bank trust departments and investment counsel organizations, which are not exchange members, cannot perform is floor execution. Thus, to place broker-dealers managing accounts for nonnatural persons on the same footing as bank trust departments and investment counsel organizations, it was necessary to prevent the broker-dealers from performing floor executions for their managed accounts for nonnatural persons. There is no need for any other restriction on the activities of broker-dealers to achieve this end of equality.

Today, as an example, if a broker-dealer money manager charges x cents per share or x percent of dollar value for a given transaction, approximately, y cents per share or y percent of dollar value represents the cost and profit of the upstairs trading, floor comparison, P. & S. comparison, clearance and the cost and profit of its money management including research, and x minus y cents per share, z , or x minus y percent of dollar value, z , the floor execution.

The nonmember financial institutions, bank trust departments, investment counsel organizations and insurance companies, can do any of the foregoing other than floor execution and charge for the same as part of its advisory fee or in additional service charges. We believe it was the committee's intent to permit the broker-dealer money manager to charge for such services either by an advisory fee based on assets or on transactions plus service charges or by a "brokerage charge" of so many cents per share or a percentage of dollar value for a given transaction provided that it does not execute the floor execution for nonnatural person accounts nor retain the charge for such floor execution, z in my above example.

From this it follows that there should be no restriction on the ability of broker-dealers as well as bank trust departments and investment counsel organizations to charge and retain compensation for all brokerage functions other than floor executions performed for nonnatural persons, and we respectfully recommend that this committee confirm the correctness of this analysis and direct the Securities and Exchange Commission to issue a rule to this effect.

In addition, as the committee knows, section 11(a) is a compromise intended to deal with what Congress felt was the unfair competitive advantage that member firms had over institutional money managers, bank trust departments and investment counsel organizations, by virtue of the ability of the member firms to do floor executions for managed accounts of nonnatural persons. The compromise was that broker-dealers were prohibited from doing floor executions for managed accounts of nonnatural persons and

institutions were prevented from becoming members of exchanges. We believe that the following three types of situations are consistent with the premises underlying the compromise.

1. Professional corporations established for natural persons. Section 11(a) (1) (E) we believe was adopted to provide an exemption for natural persons as well as for trusts and estates of natural persons. The specific language does not extend to professional corporations established by natural persons (e.g., doctors and lawyers) primarily to enable them to establish and maintain pension and profit-sharing and similar plans for themselves and their employees. In substance, however, there is in fact little, if any, difference between this type of entity and the natural persons for whom it is an alter ego. We believe the committee report should speak to this issue and say that the Commission should issue a rule in this area.

2. Non-financial institutions that are nonnatural persons. The Committee should direct the Securities and Exchange Commission to issue a rule pursuant to section 11(a) (1) (H) to provide an exemption for all nonfinancial institutions that are nonnatural persons. Section 11(a) was never intended to prevent brokers from acting as brokers and managing nonfinancial institution nonnatural persons. There was no question of any anticompetitive position.

In addition there is a third rule which we would request and this is what we call the small nonnatural person account. Firms desiring money management for amounts less than \$250,000 or some such figure have as alternatives only nondiscretionary brokers, mutual funds and bank common trust funds. None of these provide individualized money management. Thus in the absence of such an exemption these accounts are in large part prohibited from obtaining individual money management.

In this regard I did a personal analysis of the major investment advisers to see the minimum requirements that they have. Most will stay within the requirement level of approximately \$250,000. Thus a corporation with \$75,000 to have managed has no alternative.

During the 18-month deferral all interested parties in trying to come forth with a new resolution should consider the concern that has been voiced by spokesmen for certain institutions, nonmember firms, that unless Section 11(a) stands, it will be necessary for certain institutions to join exchanges in order to avoid litigation, even if they would otherwise consider membership undesirable from a business point of view. It was our original conception that this problem could be dealt with by means of a legislative affirmation that a determination, not to join an exchange, is not a breach of the institution's fiduciary obligations to the beneficiaries of accounts managed by the institution so long as the fiduciary reaches an informed business decision that is not unreasonable under the circumstances.

This is in substance the view expressed by the Court of Appeals for the Second Circuit in the case of *Tannenbaum v. Zeller*. On further reflection however we do not believe that this approach would suffice, since it would leave open for litigation the question of what is and what is not an informed business judgement. Consequently we would suggest for consideration by all interested parties

during such 18-month period an amendment to section 11(a) along the following lines:

No provision of Federal or State law shall be constructed to require any nonnatural person to join any national securities exchange to recapture brokerage commission for its own account nor any person, whether natural or non-natural, to join any such exchange to recapture brokerage commissions for any account with respect to which it or any associated person exercises investment discretion. In any such case, a determination by the board of directors or other decisionmaking body exercising similar authority of the entity whose portfolio transactions gave rise to brokerage commission not to seek such membership shall be conclusive and binding.

Thank you for the opportunity to express the view of our firm.
[Mr. Nelson's prepared statement follows:]

STATEMENT OF STUART K. NELSON, MANAGING DIRECTOR AND GENERAL COUNSEL,
SANFORD C. BERNSTEIN & Co., INC.

My name is Stuart K. Nelson. I am Managing Director and General Counsel of Sanford C. Bernstein and Co., Inc., a member firm of the New York Stock Exchange, Inc. and a Registered Investment Advisor. On behalf of my firm, I wish to express my appreciation for the opportunity to testify before this Committee.

Our firm is in the research and money management business. It provides so-called "institutional research" to major financial institutions and also provides discretionary management of individual client's portfolios. The firm also manages money on a discretionary basis for other investors, including but not limited to corporations and accounts subject to the requirements of the Employee Retirement Income Security Act of 1974. In all of these capacities, we obviously have a significant interest in Section 11(a) of the Securities Exchange Act of 1934 and we have followed with great interest the attempts at explication of this section on the part of the industry, the Securities and Exchange Commission, and the Congressional Committees.

We wish to join with the Securities and Exchange Commission and the Securities Industry Association in recommending an 18 months' deferral to afford all interested parties an opportunity to come forth with a new resolution acceptable to a broad spectrum of interested parties, and in helping with a pluralistic resolution in the public interest. We would request that the Committee in its report deal with the concurrent 18 months' deferral necessary for purposes of the Employee Retirement Income Security Act of 1974.

If this deferral is not approved by Congress, then we believe the legislators and regulators should address themselves to the following issues:

In its report dated November 15, 1977, the Joint Committee of the Subcommittee on Consumer Protection and Finance and the Subcommittee on Oversight and Investigations stated that:

"a primary purpose of Section 11(a) was to place broker-dealers with managed accounts [of non-natural persons] on the same footing as their competitors, such as bank trust departments and investment counsel organizations. Those account managers which are not brokers do arrange for others to execute transactions for accounts [of non-natural persons] under their management. Accordingly, account managers which are brokers should be able to engage in similar activities. Furthermore, the stable revenue source which the money management business affords brokers has always been recognized as desirable and in the public interest, for it helps to dampen the fluctuations in revenues to which brokers are typically subject."

The Committee agreed that it was permissible under Section 11(a) for an exchange member to arrange for another member to execute transactions which the first member orders on behalf of an account of a non-natural person under its management. However, the Committee expressed the view that it would be "clearly unlawful" under Section 11(a) for the broker with the managed account to retain any compensation for making such arrangements.

In making such determinations, we assume that the Committee considered the following. "Customary brokerage" is divided into four separate functions, as follows:

A. "Upstairs" trading;

B. Floor execution;

C. Floor comparison and purchase and sale comparison; and

D. Clearance (including cage, dividend and stock record, and margin).

With the exception only of floor execution, each of these functions may be, and in fact often is, performed by bank trust departments and investment counsel organizations. The only function that bank trust departments and investment counsel organizations, which are not exchange members, cannot perform is floor execution. Thus, to place broker-dealers managing accounts for non-natural persons on the same footing as bank trust departments and investment counsel organizations, it was necessary to prevent the broker-dealers from performing floor executions for their managed accounts for non-natural persons. There is no need for any other restriction on the activities of broker-dealers to achieve this end.

Today, as an example, if a broker-dealer money manager charges $X\epsilon$ per share or $X\%$ of dollar value for a given transaction, approximately, $Y\epsilon$ per share or $Y\%$ of dollar value represents the cost and profit of the upstairs trading, floor comparison, purchase and sale comparison, clearance, and the cost and profit of its money management including research, and X minus $Y\epsilon$ per share, Z , or X minus $Y\%$ of dollar value, Z , the floor execution.

The non-member financial institutions (i.e., bank trust departments, investment counsel organizations, and insurance companies) can do any of the foregoing other than floor execution and charge for the same as part of its advisory fee or in additional service charges. We believe it was the Committee's intent to permit the broker-dealer money manager to charge for such services either by an advisory fee based on assets or on transactions plus service charges or by a "brokerage charge" of so many cents per share or a percentage of dollar value for a given transaction provided that it does not execute the floor execution for non-natural person accounts nor retain the charge for such floor execution (Z in above example).

From this it follows, that there should be no restriction on the ability of broker-dealers (as well as bank trust departments and investment counsel organizations) to charge and retain compensation for all brokerage functions other than floor executions performed for non-natural persons and we respectfully recommend that this Committee confirm the correctness of this analysis and direct the Securities and Exchange Commission to issue a rule to this effect.

In addition, as the Committee knows, Section 11(a) is a compromise intended to deal with what Congress felt was the unfair competitive advantage that member firms had over institutional money managers (bank trust departments and investment counsel organizations) by virtue of the ability of the member firms to do floor executions for managed accounts of non-natural persons. The compromise was that broker-dealers were prohibited from doing floor executions for managed accounts of non-natural persons and institutions were prevented from becoming members of exchanges. We believe that the following three types of situations are consistent with the premises underlying the compromise:

1. PROFESSIONAL CORPORATE ESTABLISHED FOR NATURAL PERSONS

Section 11 (a) (1) (E) was adopted to provide an exemption for natural persons as well as for trusts and estates of natural persons. The specific language does not extend to professional corporations established by natural persons (e.g. doctors and lawyers) primarily to enable them to establish and maintain pension and profit-sharing and similar plans for themselves and their employees. In substance, however, there is in fact little if any difference between this type of entity and the natural persons for whom it is an alter ego. Since the reasoning of Congress in permitting broker-dealers to render advice to and to execute transactions for natural persons is equally applicable to this type of entity, it should be made clear by this Committee that this type of entity is within the ambit of Section 11 (a) (1) (E).

2. NON-FINANCIAL INSTITUTIONS THAT ARE NON-NATURAL PERSONS

The Committee should direct the Securities and Exchange Commission to issue a rule pursuant to Section 11(a) (1) (H) to provide an exemption for all non-financial institutions that are non-natural persons. Section 11(a) was

never intended to prevent brokers from acting as brokers and managing non-financial institution non-natural persons. There was no question of any anti-competitive position. What is the sense of Widget Corporation, a company making widgets which wants a broker-dealer money manager to manage its account completely, from doing business with our firm completely, including the floor execution. Surely Widget Corporation does not wish to become a member of a national stock exchange.

3. SMALL NON-NATURAL PERSON ACCOUNTS

The Committee should direct the Securities and Exchange Commission to issue a rule pursuant to Section 11(a) (1) (H) to provide an exemption for broker-money managed accounts under some dollar figure (e.g. \$250,000). These customers have as alternatives primarily non-discretionary brokers, mutual funds and bank common trust funds. None of these provides individualized money management. Thus, in the absence of an exemption, these accounts are in large part prohibited from obtaining individual money management.

During the 18 months' deferral, all interested parties in trying to come forth with a new resolution, should consider the concern that has been voiced by spokesmen for certain institutions (non-member firms) that unless Section 11(a) stands, it will be necessary for certain institutions to join exchanges in order to avoid litigation, even if they would otherwise consider membership undesirable from a business point of view. It was our original conception that this problem could be dealt with by means of a legislative affirmation that a determination, not to join an exchange, is not a breach of the institutions fiduciary obligations to the beneficiaries of accounts managed by the institution so long as the fiduciary reaches an informed business decision that is not unreasonable under the circumstances.

This is in substance the view expressed by the Court of Appeals for the Second Circuit in the case of *Tannenbaum v. Zeller*. On further reflection, however, we do not believe that this approach would suffice, since it would leave open for litigation the question of what is and what is not an informed business judgment. Consequently, we would suggest, for consideration by all interested parties, during such 18 months' period, an amendment to Section 11(a) along the following lines:

"No provision of federal or state law shall be constructed to require any non-natural person to join any national securities exchange to recapture brokerage commissions for its own account, nor any person, whether natural or non-natural, to join any such exchange to recapture brokerage commissions for any account with respect to which it or any associated person exercises investment discretion. In any such case, a determination by the Board of Directors (or other decision making body exercising similar authority) of the entity whose portfolio transactions gave rise to brokerage commission not to seek membership shall be conclusive and binding."

In view of the nature and purpose of these hearings, I have not addressed myself to any legislation that may be required to deal with any problems that may arise under the Employee Retirement Income Security Act of 1974. I would hope that if the views I have expressed commend themselves to this Committee they would also commend themselves to the appropriate Committee dealing with problems under the Employee Retirement Income Security Act of 1974.

Thank you for the opportunity to express the views of our firm.

Mr. ECKHARDT. Thank you.

Mr. Roulston.

STATEMENT OF THOMAS ROULSTON

Mr. ROULSTON. Mr. Chairman, members of the committee, I appreciate the opportunity of allowing someone other than from New York or Washington to testify.

My name is Thomas Roulston. I am president of Roulston & Co., which is headquartered and has its only U.S. office in Cleveland.

We employ about 70 persons. We are a research firm and, unlike my compatriots here, over 50 percent of our revenues come from managed accounts

In 1977 over 95 percent of our clients paid us through the commission route rather than through the route of a fee, which we offer them as an option. That is the way it has been for the 15 years since I founded the firm.

By the way, to answer Mr. Broyhill's question, we believe that our group, that is, the four of us and the rest of the people, manage between 3 to 5 percent of ERISA assets in the United States. This is adding up everything that we can add up and adding up our competitors. We are a very small part of the industry.

I have about 1½ minutes of remarks I would like to make to the committee which I think are more pointed from a regional view. The smaller money managers and brokerage firms such as Roulston & Co. provide services which are currently being used to the advantage of many millions of individuals covered under pension and profit-sharing plans under broker-dealer money management.

Section 11(a) prohibits effective May 1, 1978 our being paid for this service in our normal historic fashion and leaving to Government agencies the ground rules on how we can be paid in an alternative basis. Those details and ground rules have neither been worked out nor directed as we all anticipated they would be 3 years ago.

If the current law remains unamended with our franchise to do our major business economically expiring on May 1, 1978, the larger institutional money management firms will have the opportunity to take over either Roulston & Co. and other firms like it or our business with congressional sanction.

I am asking Congress to extend the deadline of the effectiveness of 11(a) until the Government agencies involved provide the details of the options available to us to remain in our historic business.

I would be very happy to answer any questions. We happen to be a firm, unlike the other people here, whom we see if you don't extend this date, we see ourselves having to sell out to a major firm, the big insurance companies, the big investment counselors or somebody else or to close up.

We have been pressing this issue. I was unaware until last November when I happened to come down here that this point was not being made either before Congress or before the SEC. Thank you.

Mr. ECKHARDT. Mr. Broyhill?

Mr. BROYHILL. Mr. Roulston, you are not a broker?

Mr. ROULSTON. Yes, I am a broker. I am a member of the New York Stock Exchange, American Stock Exchange, Midwest Stock Exchange. A registered investment counselor, yes.

Mr. BROYHILL. So your income is derived from trading accounts?

Mr. ROULSTON. Fifty percent of our income comes from managing accounts. Correct. We have no retail business and no underwriting business. We structure that so we don't have a conflict of interest.

Mr. BROYHILL. Would you not still be able to manage the accounts for a fee?

Mr. ROULSTON. Correct. Well, yes, we could manage the accounts for a fee. But I believe, as Mr. Zicklin and Mr. Garil pointed out, at this point we have 2 months until D-day. It is impossible for us

to even reprogram our computer into a fee structure. We have 156 fiduciary accounts today. These range from some of the biggest companies to some of the smallest ones, who couldn't get money management elsewhere.

First of all we would have to come up with our own document and go to 156 sets of lawyers to have those documents approved to go on a fee basis May 1. With our size organization there is no possible way we can work with 156 investment advisory agreements and get it through and passed by 156 law firms by May 1. So time is critical to us.

Mr. BROYHILL. You are saying and the others are saying that you could not compete if you were just in the management side. Mr. Zicklin, I think you made that statement that you could not compete.

Mr. ZICKLIN. I don't think I made the statement we could not compete. We would lose a certain part of our business. My guess is that we would have to raise the fees to compensate for it.

Mr. BROYHILL. I will have to go back and look at your statement. I thought you said there were going to be barriers to competition.

Mr. ZICKLIN. I think there will be barriers to competition.

Mr. BROYHILL. Why? I don't understand.

Mr. ZICKLIN. The historical methodology of doing business would be erased. Small accounts that paid a commission would be faced with a fee. A commission would be involved somewhere else if you had to take that order elsewhere.

Mr. BROYHILL. Why could you not compete then?

Mr. ZICKLIN. Let's take the definition first of effect. If the broad definition of effect is used, the Commission's definition, we couldn't get that order anywhere else. We would have to lose the account. We wouldn't be empowered to place the order somewhere else. You can't go to these accounts and say to them, "We think you ought to buy General Motors." They have no trading desk. They can't go buy General Motors somewhere else.

Mr. BROYHILL. I know. But this is a point that has been debated somewhat. This committee along with the Subcommittee on Oversight and Investigations issued a report last year in which it stated that the legislative history of section 11(a) is replete with statements making clear that that section was not designed to preclude exchange members from having managed accounts. Do you agree with that?

Mr. ZICKLIN. We completely agree.

Mr. BROYHILL. It goes on to say the primary purpose of 11(a) was to place broker-dealers with managed accounts on the same footing as their competitors such as bank trust departments, investment counsel organizations—

Mr. ROULSTON. Mr. Broynhill, if I can express myself on that, nowhere did Congress ever give us the right to have checking accounts, to get us in the banking business, to be in competition with the banks. What I am saying is, to get back to the direct question—

Mr. BROYHILL. Wait a minute. Are you saying that the banks would charge a lower fee—

Mr. ROULSTON. Because they have other banking business with that client. Absolutely, sir.

Mr. BROYHILL. Why don't you elaborate on that point?

Mr. ROULSTON. Certainly. A bank's entire relationship with—

Mr. BROYHILL. You have got to assume I don't know anything about this.

Mr. ROULSTON. A bank's entire relationship with a client involves different fee structures on all the different items.

Mr. BROYHILL. And you say you cannot compete with a bank?

Mr. ROULSTON. Not a firm like Roulston & Co. that does only one thing. We neither loan money nor do we provide any banking services. We only provide one thing.

Mr. BROYHILL. What type of fees does a bank normally charge?

Mr. ROULSTON. Interest on the money.

Mr. BROYHILL. What type of fees do they charge an account? Are you saying they are fees so low you couldn't match them and stay in business?

Mr. ROULSTON. No, what I am saying, sir, is the fact that we do not offer the other services that the bank does.

Mr. BROYHILL. Let's just address the fee itself. You couldn't stay in business on the fee that the banks charge?

Mr. ROULSTON. That is true of Roulston & Co., yes, sir.

Mr. BROYHILL. What about the rest of you?

Mr. GARIL. The New York Federal Reserve every year puts out figures on the profitability of trust companies, trust operations. The numbers are very interesting. I have not seen the latest figures. The bank trust operations lose huge amounts of money. This study takes a derived interest income figure that is offset against that. Only after the interest income do the banks turn into the black.

But the top 10 New York banks for many years, just looking at those, have lost many millions of dollars. In some of my earlier statements I know I had those figures and have placed them in the record. I will be glad to provide you with those figures. But it is a subsidized operation.

Mr. BROYHILL. That is most interesting because it was our statement in the report of last year that the purpose was to place broker-dealers with managed accounts on the same footing with their competitors. You are telling me this would not occur, you would not be on the same footing. Your competitors would have some other source of revenue that you would not enjoy.

Mr. ROULSTON. Absolutely. I don't want to be put on the same footing as anybody. I am not asking for an office in New York. I am not interested in paying the rents they pay in New York. I am not asking to be put on the same footing. I am merely asking for the opportunity to serve clients in a fair and honorable way, and have those clients pay me in a manner that I set down and prescribe. For 15 years my firm has derived the majority of its revenue—I am a minority of one at this table—from commissions on a managed account. We have never had a complaint against us at the SEC or anywhere else. We charge approximately twice what a bank does.

Mr. BROYHILL. You are saying your competitors get income that enables them to make up their losses?

Mr. ROULSTON. Yes, sir.

Mr. BROYHILL. What are those?

Mr. ROULSTON. Checking accounts. Commercial accounts. Whatever other business they do with a bank. They would also have a trust account, I would imagine.

Mr. BROYHILL. You say you can document this?

Mr. GARIL. There is an annual report prepared by the New York Federal Reserve which does show this, these figures.
[The information referred to follows:]

SURVEY OF EARNINGS AND EXPENSES OF TRUST DEPARTMENTS IN THE SECOND
FEDERAL RESERVE DISTRICT FOR 1976

The twenty-fourth annual survey of trust department earnings and expenses was conducted in cooperation with the Trust Division of the New York State Bankers Association and was compiled from data provided by 72 member banks in the District each with total commissions and fees of \$100,000 or more. As a group, these banks reported total commissions and fees of \$510,109,000 including ten major New York banks with gross trust fees of \$440,202,000. The trust commissions of the banks participating in the survey account for about 97 percent of all such income of member banks in the District.

The ten major New York banks are represented by the following: The Bank of New York; Bankers Trust Company; The Chase Manhattan Bank, N.A.; Chemical Bank; Citibank, N.A.; Irving Trust Company; Manufacturers Hanover Trust Company; Marine Midland Bank; Morgan Guaranty Trust Company of New York and United States Trust Company of New York.

The survey disclosed that, excluding ten major New York banks, commissions of \$69,907,000 were earned in 1976 by 62 reporting banks with a corresponding expense total of \$72,722,000 which resulted in a net operating loss of \$2,815,000. A detailed breakdown of this data is as follows:

Commission range	Number of banks	Total commissions	Total expenses	Net operating earnings (losses)
\$100,000 to \$199,999	8	\$1,197,000	\$1,363,000	(\$166,000)
\$200,000 to \$299,999	10	2,332,000	2,415,000	(83,000)
\$300,000 to \$399,999	6	2,111,000	2,235,000	(124,000)
\$400,000 to \$499,999	6	2,616,000	3,081,000	(465,000)
\$500,000 to \$599,999	3	1,564,000	1,745,000	(181,000)
\$600,000 to \$699,999	2	1,233,000	1,628,000	(395,000)
\$700,000 to \$799,999	2	1,470,000	1,181,000	289,000
\$800,000 to \$899,999	4	3,365,000	3,360,000	(5,000)
\$900,000 to \$999,999	3	2,672,000	2,893,000	(131,000)
\$1,000,000 and over	18	51,257,000	52,791,000	(1,534,000)
Totals	62	69,907,000	72,722,000	(2,815,000)

As a group, these 62 reporting banks generated 13.3% of the total trust commissions earned by all member banks in the District.

The average rate of credit for the 62 trust departments was 5.77% in 1976 compared with 5.61% in 1975. For the major New York institutions, the average rate allowed on deposits was 5.91% in 1976 and 7.07% in 1975. This credit is essentially an accounting procedure and does not represent actual revenue to the trust department, but rather relates to earnings in the commercial banking department from use of the balances generated by trust department accounts. The total cash balances upon which credit was allowed in 1976 represented less than 1.5% of total trust assets held by all participating banks.

Table I, which indicates the percentage distribution of trust department commissions and expenses for reporting banks, excluding ten major New York institutions, provides participants with a basis for comparison of their own trust department income and expense data. The table indicates that total expenses were 104% of total commissions and fees compared to 107.5% in 1975. It should be noted that 31 of the 62 departments included in Table I had net operating losses before allowed credits. After applying such credits, the number of departments with losses was reduced to 17.

Table II presents five-year trend data of trust department income and expenses for 42 banks. Participating banks may use this table to compare the trend of their trust income and expenses over the past five-year period.

Table III presents five-year trend data of trust department income and expenses for the ten major New York banks.

The ten major New York banks produced 83.7% of the total trust commissions and fees generated by member banks in the District. As a group, these banks reported net operating losses of \$64,609,000, which represents a decrease of \$18,384,000, or 22.2%, from 1975. A contributing factor toward this improved

TABLE I.—Percentage distribution of trust department income and expenses and related items in 1976 for all reporting banks excluding 10 major New York banks

Commissions and fees:		Percent
Estates.....	-----	17.6
Personal trusts.....	-----	36.9
Employee benefit trusts.....	-----	8.6
Personal agencies.....	-----	27.5
Corporate trusts.....	-----	2.0
Corporate agencies.....	-----	7.4
Total commissions and fees.....	-----	100.0
Expenses (All expenses are ratios of total commissions and fees):		
Salaries and wages:		
Officers.....	-----	26.5
Employees.....	-----	23.3
Pensions.....	-----	3.3
Personnel insurance.....	-----	2.4
Other expenses related to salaries.....	-----	4.3
Subtotal.....	-----	59.8
Occupancy of quarters.....	-----	8.9
Furniture and equipment.....	-----	3.1
Stationery, supplies and postage.....	-----	3.1
Telephone and telegraph.....	-----	1.7
Advertising.....	-----	.9
Directors and trust committee fees.....	-----	.5
Legal and professional fees.....	-----	1.5
Periodicals and investment services.....	-----	1.6
Examinations.....	-----	.5
Other direct expenses.....	-----	10.3
Total direct expenses.....	-----	91.5
Overhead.....	-----	12.5
Total expenses.....	-----	104.0
Net operating earnings (losses) before taxes.....	-----	(4.0)
Allowed credits for deposits.....	-----	21.8
Net earnings.....	-----	17.8
Related items:		
Average rate of allowed credit.....	-----	5.77
Total commissions and fees.....	-----	\$69,907,000
Total expenses.....	-----	72,722,000

TABLE II.—5-YR TREND OF TRUST DEPARTMENT INCOME AND EXPENSES FOR 42 BANKS EXCLUDING 10 MAJOR

[In thousands of dollars]

	Estates	Personal trusts	Em- ployee benefit trusts	Personal agencies	Cor- porate trusts and agencies	Total com- mis- sions and fees	Total ex- penses	Net oper- ating earnings (losses) before income taxes	Allowed credits for deposits	Net earnings
1972.....	\$10,569	\$14,329	\$2,807	\$8,148	\$4,570	\$40,423	\$36,811	\$3,612	\$9,617	\$13,229
1973.....	11,018	15,706	3,399	8,496	5,261	43,880	41,925	1,955	12,233	14,188
1974.....	12,247	15,524	3,542	8,289	5,440	45,042	46,136	(1,094)	13,111	12,017
1975.....	10,896	16,225	4,028	9,556	5,164	45,869	47,697	(1,828)	10,981	9,153
1976.....	9,518	19,613	4,509	10,220	6,028	49,888	51,170	(1,282)	11,339	10,057

performance was that total expenses increased \$41,383,000, or 8.9%, over 1975 while total commissions increased \$59,767,000, or 15.7%, over the previous year. Furthermore, an increase in trustees' annual statutory commissions for trusts created after August 31, 1956 became effective June 8, 1976 and therefore impacted upon commissions taken subsequent thereto. Only two of the participating banks reported that their trust functions achieved a net operating profit for 1976.

After applying allowed credits for deposits, eight departments had profitable operations.

Significant increases in commissions were realized in the following categories: employee benefit trusts \$20,748,000; personal trusts \$14,315,000 and custodian \$10,593,000.

TABLE III.—5-YR TREND OF TRUST DEPARTMENT INCOME AND EXPENSES BY TYPE OF ACCOUNT FOR 10 MAJOR NEW YORK BANKS

[In thousands of dollars]

	Total commissions and fees	Total expenses	Net operating earnings (losses) before income taxes	Allowed credits for deposits	Net earnings
Estates:					
1972	\$22,714	\$16,121	\$6,593	\$2,433	\$9,026
1973	20,324	17,909	2,415	3,713	6,128
1974	22,073	19,378	2,695	4,071	6,766
1975	19,915	22,574	(2,659)	2,266	(393)
1976	19,363	23,590	(4,227)	2,412	(1,815)
Personal trusts:					
1972	62,398	56,378	6,020	12,818	18,838
1973	64,525	58,777	5,748	16,964	22,712
1974	61,770	67,254	(5,484)	21,402	15,918
1975	59,086	74,720	(15,634)	14,751	(883)
1976	73,401	82,681	(9,280)	12,312	3,032
Employee benefit trusts:					
1972	62,844	58,239	4,605	16,221	20,826
1973	74,792	59,665	15,127	25,313	40,440
1974	87,284	69,603	17,681	24,527	42,208
1975	87,292	78,387	8,905	13,711	22,616
1976	108,040	93,003	15,037	10,681	25,718
Investment advisory:					
1972	41,311	35,377	5,934	7,043	12,977
1973	45,057	38,297	6,760	10,186	16,946
1974	41,557	41,713	(156)	12,571	12,415
1975	40,259	44,654	(4,395)	8,248	3,853
1976	47,814	49,964	(2,150)	5,966	3,816
Custodian:					
1972	37,955	46,835	(8,880)	26,128	17,248
1973	41,159	48,477	(7,318)	41,493	34,175
1974	41,944	58,531	(16,587)	45,593	29,006
1975	44,005	63,089	(19,084)	30,073	10,989
1976	54,598	74,442	(19,844)	24,327	4,493
Total estates, trusts, and agencies:					
1972	227,222	212,950	14,272	64,643	78,915
1973	245,857	223,125	22,732	97,669	120,401
1974	254,628	256,479	(1,851)	108,164	106,313
1975	250,557	283,424	(32,867)	69,049	36,182
1976	303,216	323,680	(20,464)	55,698	35,234
Corporate trusts:					
1972	27,804	15,319	2,485	10,164	12,650
1973	29,019	27,686	333	19,726	20,059
1974	30,949	30,892	57	28,266	28,323
1975	39,762	39,964	(202)	21,459	21,257
1976	43,525	44,470	(945)	23,688	22,743
Stock transfer:¹					
1972	72,385	84,442	(12,057)	8,306	(3,751)
1973	65,586	98,094	(32,508)	11,631	(20,877)
1974	62,191	95,488	(33,297)	16,962	(16,335)
1975	59,247	100,666	(41,419)	11,698	(29,721)
1976	63,074	100,699	(37,625)	10,846	(26,779)
Other corporate agencies:					
1972	33,762	33,244	518	22,791	23,309
1973	35,027	38,662	(3,635)	37,183	33,548
1974	36,015	41,428	(5,413)	48,812	43,399
1975	30,869	39,374	(8,505)	26,115	17,610
1976	30,387	35,962	(5,575)	21,161	15,586
Total corporate trusts and agencies:					
1972	133,951	143,005	(9,054)	41,262	32,208
1973	128,632	164,442	(35,810)	68,540	32,730
1974	129,155	167,808	(38,653)	94,040	55,387
1975	129,878	180,004	(50,126)	59,272	9,146
1976	136,986	181,131	(44,145)	55,695	11,550
Totals					
1972	361,173	355,955	5,218	105,905	111,123
1973	374,489	387,567	(13,078)	166,209	153,131
1974	383,783	424,287	(40,504)	202,204	161,700
1975	380,435	463,428	(82,993)	128,321	45,328
1976	440,202	504,811	(64,609)	111,393	46,784

¹ Figures for 1972 and 1976 represent data from seven major New York banks. Figures for 1973, 1974, and 1975 represent data from 8 such banks.

The functions that suffered material net operating losses in 1976 were: stock transfer \$37,625,000; custodian \$19,844,000; personal trusts \$9,230,000 and other corporate agencies \$5,575,000. Net operating profits were reported only in employee benefit trusts—\$15,037,000, which was an increase of \$6,132,000, or 68.9%, when compared with 1975 results.

Net earnings rose \$1,456,000, or 3.2%, from 1975 results. This increase, while hindered greatly by lower interest rates in 1976, was attributable to vastly improved net operating results recorded during the period. The average rate of credit applied in 1976 was 5.91% on average balances of \$1.885 billion as compared with 7.07% on average balances of \$1.814 billion in 1975. As a result, the allowed credit declined \$16,928,000; however, this deficit was overcome by an \$18,384,000 decline in net operating losses. It should be noted that \$1.354 billion, or 72%, of the total average balances upon which credit was allowed in 1976, was generated by custody and corporate trust and agency activities. In the aforementioned areas, the amount of balances maintained is not within the control of the trust department.

The trust activity that has experienced the greatest improvement in profitability over the past five-year period has been the employee benefit area. During this period, commissions have risen 71.9% while expenses have increased only 59.7%. Net operating earnings for the period have increased 226%.

Tables IV and V present detailed data relating to direct, indirect and allocated expenses for the various income producing functions in the personal and corporate trust areas, respectively, of the ten major New York banks.

TABLE IV.—DISTRIBUTION OF 1976 PERSONAL TRUST DEPARTMENT INCOME AND EXPENSES DETAIL
FOR 10 MAJOR NEW YORK BANKS

[In thousands of dollars]

	Estates	Personal trusts	Employee benefit trusts	Investment advisory	Custodian	Total
Commissions and fees.....	\$19,363	\$73,401	\$108,040	\$47,814	\$54,598	\$303,216
Direct expenses:						
Officers salaries.....	3,527	6,586	5,121	2,796	2,679	20,709
Employees salaries.....	1,713	3,630	4,282	1,737	3,624	14,986
Outside help.....	6	23	469	10	21	529
Salary related expenses.....	1,489	2,873	2,570	1,322	1,792	10,046
Subtotal.....	6,735	13,112	12,442	5,865	8,116	46,270
Quarters:						
Occupancy of quarters.....	1,032	2,105	1,892	1,086	1,083	7,198
Furniture and equipment.....	84	151	268	105	188	796
Other direct expenses.....	803	1,695	2,897	926	3,078	9,399
Subtotal.....	1,919	3,951	5,057	2,117	4,349	17,393
Total direct expenses.....	8,654	17,063	17,499	7,982	12,465	63,663
Indirect expenses:						
Institutional and other service departments.....	1,603	3,265	5,791	1,536	2,802	14,997
Overhead.....	1,675	4,875	2,132	2,700	1,068	12,450
Total indirect expenses.....	3,278	8,140	7,923	4,236	3,870	27,447
Total direct and indirect expenses.....	11,932	25,203	25,422	12,218	16,335	91,110
Departmental allocations:						
General administration and other staff and support.....	5,637	17,307	18,734	10,168	8,759	60,605
Operations.....	4,211	25,859	34,699	13,942	50,030	128,741
Investment research.....	344	3,704	6,134	3,162	254	13,598
Portfolio management.....	1,492	11,269	9,487	11,347	2,797	36,392
Total departmental allocations.....	11,684	58,139	69,054	38,619	61,840	239,336
Subtotal.....	23,616	83,342	94,476	50,837	78,175	330,446
Less: Credits for services to other departments.....	26	661	1,473	873	3,733	6,766
Total expenses and allocations.....	23,590	82,681	93,003	49,964	74,442	323,680
Net operating earnings (losses) before taxes.....	(4,227)	(9,280)	15,037	(2,150)	(19,844)	(20,464)
Allowed credits for deposits.....	2,412	12,312	10,681	5,966	24,327	55,698
Net earnings.....	(1,815)	3,032	25,718	3,816	4,483	35,234

TABLE V.—DISTRIBUTION OF 1976 CORPORATE TRUST DEPARTMENT INCOME AND EXPENSES DETAIL FOR 10 MAJOR NEW YORK BANKS

[In thousands of dollars]

	Corporate trusts	Stock transfer ¹	Other corporate agencies	Total
Commissions and fees.....	\$43, 525	\$63, 074	\$30, 387	\$136, 986
Direct expenses:				
Officers salaries.....	3, 117	2, 317	1, 592	7, 026
Employees salaries.....	5, 014	7, 718	5, 281	18, 013
Outside help.....	215	231	263	769
Salary related expenses.....	2, 462	3, 082	2, 055	7, 599
Subtotal.....	10, 808	13, 408	9, 191	33, 407
Quarters:				
Occupancy of quarters.....	1, 924	2, 737	1, 669	6, 330
Furniture and equipment.....	261	374	339	974
Other direct expenses.....	1, 409	4, 853	1, 450	7, 712
Subtotal.....	3, 594	7, 964	3, 458	15, 016
Total direct expenses.....	14, 402	21, 372	12, 649	48, 423
Indirect expenses:				
Institutional and other service departments.....	5, 289	9, 505	4, 348	19, 142
Overhead.....	2, 396	1, 323	1, 416	5, 135
Total indirect expenses.....	7, 685	10, 828	5, 764	24, 277
Total direct and indirect expenses.....	22, 087	32, 200	18, 413	72, 700
Departmental allocations:				
General administration and other staff and support.....	2, 587	4, 041	1, 690	8, 318
Operations.....	20, 711	65, 627	16, 713	103, 051
Total departmental allocations.....	23, 298	69, 668	18, 403	111, 369
Subtotal.....	45, 385	101, 868	36, 816	184, 069
Less: Credits for services to other departments.....	915	1, 169	854	2, 938
Total expenses and allocations.....	44, 470	100, 699	35, 962	181, 131
Net operating earnings (losses) before taxes.....	(945)	(37, 625)	(5, 575)	(44, 145)
Allowed credits for deposits.....	23, 688	10, 846	21, 161	55, 695
Net earnings (losses).....	22, 743	(26, 779)	15, 586	11, 550

¹ Figures for 7 major New York banks.

Mr. ZICKLIN. Mr. Broynhill, one point if I may, if the various institutions weren't on an equal footing with the member firms it would stand to reason that the member firms would have a significant number of dollars of those accounts to be managed. The last figures I saw issued by the Federal Reserve Board were that something like \$500 billion of, let's call it institutional-type money, being managed in the United States. The best figure I have been able to come up with is that the entire—I use "Wall Street"—the whole member community manages something like 10 to 15 billion. Once it was 17 billion. The other 483 billion—

Mr. BROYNHILL. Security firms are only managing a very small percentage of the total?

Mr. ZICKLIN. That is right.

Mr. ROULSTON. If we had a competitive advantage, I would think that by this time we all would not have still only 3 percent of the business, particularly since we charge approximately twice what a bank does for management. Our brokerage fees over the course of a year are approximately twice what a person would pay at a bank in fees. So he must be coming to us for something else.

Mr. BROYHILL. If this May 1st deadline is not extended are you saying that you won't lose your business to Mr. Zicklin and Mr. Zicklin to Mr. Nelson but you will lose it to someone else.

Mr. ROULSTON. Speaking for ourselves, we have already started to lose people.

Mr. BROYHILL. I am talking about your volume, your business.

Mr. ROULSTON. Our business, I would imagine, would go to major big banks and to big investment counselors, who I understand oppose the extension of this. And I would too if I were them because it is 3 percent of the total business up for grabs if this is not extended.

Mr. ZICKLIN. In a reply we made to the SEC's request for comment, we indicated that we were already affected and this goes back 2 years ago. I want you to put yourself in the position of someone managing a nonnatural account for the purposes of this act, giving the account to someone who might not be able to manage it in the same way 1 year hence, or 2 years hence, depending on the timing.

We have had difficulty in acquiring new accounts because they want to know are we going to be in this business 1 year from now or 2 years from now. That is a difficulty we have experienced and I am sure other people on this panel have experienced, given the uncertainty of May 1.

Can I refer back to something?

Mr. BROYHILL. Sure.

Mr. ZICKLIN. You gave the subcommittee a definition of the word "effect" which I understand was also a Commission definition of the word "effect." The SIA came to the subcommittee and said they would support 11(a) if their definition of the word "effect" were employed.

Depending on that definition of the word "effect" some of us might have to leave the exchanges or the money management business or restructure our business. We don't know the definitive definition of the word "effect." How does one do that in the period remaining?

Mr. BROYHILL. I assume you have read this?

Mr. ZICKLIN. Yes, sir, I have.

Mr. BROYHILL. Thank you, Mr. Chairman.

Mr. ECKHARDT. You all seem to give testimony here that supports the proposition of actually repealing 11(a). Do I draw from your statements that you would prefer that that be done?

Mr. ROULSTON. Speaking only for myself, the answer is yes, Mr. Chairman.

Mr. GARIL. In the prior times I testified before, I tried to point out that 11(a) at least in my opinion made little or no sense. I still believe that is the case. I don't know how realistic repeal is. It is something that was considered last year by your committee along with Chairman Moss' subcommittee. The decision was made at that time that that was not the proper route to take.

I think we will be forced to deal with a much more specific issue, that being an extension of time to resolve some of these practical problems.

Mr. ECKHARDT. How would extension of time enable you to deal with the practical problems? This has been pending for 3 years.

Mr. GARIL. It has been pending for 3 years. But the changes that have been occurring in our business have been so great. It was not until about a month ago that the Commission brought out its most recent release on the national market system, which, while probably more definitive, I am sure is not the ultimate document. There will be changes in the working definition of what an exchange member is. We don't know what that is. If I am member of the New York Stock Exchange and we have a whole system where orders are shifted around and I am a member of the Philadelphia Stock Exchange even though I am not currently a dues-paying member of that organization.

Those kinds of questions cannot be answered until we know what this national market system evolves into.

Mr. ECKHARDT. You have mentioned that there are ways in which you could accommodate to 11(a) in a prior system.

Mr. GARIL. That is correct. But things have occurred now which makes it difficult to do so because of the interrelationship of the various markets.

Mr. ECKHARDT. Do we have a definitional problem or do we have a basic philosophic or economic problem that we are confronted with?

Mr. NELSON. I think deferral would give an opportunity for the national market system to come into place. We only saw a document a month ago. Second, you will have an opportunity to reconsider the economic considerations that were raised by Mr. Roulston and Mr. Broyhill. There is the question of people going into the marketplace to serve the function of money management for the American public.

Thirdly, as for floor execution, if one wanted to put them on an equal footing so far as brokerage and money management is concerned, one could merely cutout floor execution. You might have a solution. But that would not take care of Mr. Roulston's question of the competitive advantage that some of his competitors have because they have other lines of business.

Mr. ECKHARDT. If we repeal 11(a) would it put the institutions at a competitive disadvantage?

Mr. ZICKLIN. I think you would be hard pressed to find any evidence that institutions are at a competitive disadvantage at this moment. My guess is that your staff could prove to you convincingly that the major institutions can now execute, clear, transactions at a price equal to or less than most member firms.

Mr. ECKHARDT. What if they join an exchange? Would it put broker-dealers at a disadvantage, assuming repeal of 11(a)? Suppose institutions joined exchanges after the repeal of 11(a).

Mr. BROYHILL. Would the effect of repeal be to encourage institutions to join exchanges?

Mr. ZICKLIN. If institutions join exchanges we would have no problem, talking about my firm personally. We would live with it. We would find a way. Assuming two facts. One, that they would live under the same regulation we did and, two, that they were not forced to join by any legalized set of procedures. I think there is some competitive disadvantages, to be quite frank.

I think Mr. Roulston has brought to your attention that we normally have one relationship with a client. We have relationship,

that money management relationship, rather than a myriad of relationships involving corporate loans, individual loans, insurance programs, custody accounts, the various relationships that banks or insurance companies would have. If there were a competitive disadvantage we would learn to adjust.

Mr. ECKHARDT. I have a vote on the Alaskan lands bill at the Interior Committee in about 10 minutes. Mr. Broyhill, would you please take over?

Mr. BROYHILL. Sure.

Mr. GARIL. Mr. Broyhill, if I might add something to this question of would institutions join, I think Chairman Williams was asked early today about commission rates increasing. Rates have gone up. But they have gone up in a specific area. They have gone up either in the area of superior research or they have been going up in areas where firms have been willing to risk their own capital.

If an institution were to join the exchange they would still be faced with having to buy those services. In the case of our own funds, they deal with the major research firms even though they are affiliated with a member firm. They pay those higher commissions. When they are looking for a block execution, it is necessary for those firms to put up capital. They have to deal with those firms and the benefits of exchange membership are totally irrelevant when it comes to those kinds of trades.

The thing that has not been discussed today are the numerous types of arrangements which many of our larger investment advisers and banks have set up where they are dealing on basically the same type of arrangement that member firms who do not have their own man on the floor deal with.

They deal directly with the \$2 broker and pay him the same rates and in many instances lower rates than member firms pay and have set up a correspondent relationship to have those trades cleared. They can deal with broker-dealers. They can do it through banks for that matter.

I know we serve as New York correspondent for some out-of-town firms. They are paying significantly higher rates than are the institutions who are setting up these types of arrangements basically because these institutions are larger than most out-of-town firms are. So joining an exchange would not save them any money at all. Indeed I think it would cost them a great deal more. It would create a great deal of regulation and aggravation for them which they are currently isolated from.

Mr. BROYHILL. So you do not think that repeal would result in an incentive for institutions to join an exchange or to make it profitable for them to do so.

Mr. GARIL. It would not result in any economic incentive for them to join. As Mr. Nelson said—and I believe there will be future witnesses who will say—they are concerned about a legal incentive. There have been a number of lawsuits, all based upon a situation which existed in the 1960's, where there were not only fixed rates but I think we would all agree on institutional trades there were rates for which there was no economic reality. Those rates were much too high.

Advisers were sued and in many instances have lost cases because in the 1960's environment they did not join an exchange. In the

present environment they prefer to have this legal umbrella which exists in 11(a) because they can say, "You can't sue us because even if we wanted to join the exchange, we can't." So they can sit back today and avoid the fears which they feel they would have if 11(a) were lifted.

That I think would be taken care of by using the language which Mr. Nelson suggested with some kind of assurances that the problems of the past are not really the problems of today.

Mr. ROULSTON. The ancillary question that Chairman Eckhardt posed, would we favor the repeal of 11(a)? I think what is running through all of our minds is that if we say yes and that discussion starts, "May Day" is going to come and go and some of us are going to be drastically hurt, a couple of us will be out of business, while we argue over what is the big issue.

What I came here today to testify to is a reprieve by the powers that be, here in Congress and the various Government agencies. We have tried to sit down with the agencies involved. We have run into some extremely competent staff. But we are caught in a legislative gap here until the heads—I am talking about the Secretary of Labor and Mr. Williams—can agree. Give us a longer tenure while you work out the problems. When you can tell us what to do, we will do it.

Mr. BROYHILL. I understand. You aren't asking for a pardon. You are just asking for your sentence to be reduced a little.

Mr. OPPER.

Mr. OPPER. Mr. Nelson, in describing the components of customary brokerage you were attributing, at least to the banks, the ability to perform three of the four. The insurance companies will be here to testify against the extension. Can the insurance companies perform these other three functions as well?

Mr. NELSON. In my opinion I would think so. They may choose to perform some or all of the functions. For economic reasons they may feel it is less expensive to do it externally.

Clearly the insurance companies do upstairs trading. They do all three.

Mr. OPPER. Thank you.

Mr. Roulston, do you manage your accounts on a commission basis only?

Mr. ROULSTON. We offer the customer his choice of a commission or a fee.

Mr. OPPER. You are saying that with 11(a) the customer doesn't have a choice. He is going to have to pay somebody a fee for managing his account.

Mr. ROULSTON. This raises his rates. We will charge him a fee. If the order is interpreted that way, we will have the order executed somewhere else and the guy will pay double. I imagine this is what somebody means in 11(a). But at the moment we don't know what is meant.

Mr. NELSON. The assumption is that with smaller accounts they can go to a bank or an adviser. He may not be able to if the brokerage firm chooses not to provide service or is unable to service smaller accounts.

Mr. ROULSTON. We are the only firm in Cleveland that will take an account of \$50,000, \$75,000 or \$100,000. This would take those people out of the money management business.

Mr. OPPER. Do you know whether banks provide a service for accounts that small?

Mr. ROULSTON. No bank in Cleveland takes less than \$250,000 unless there is compelling other business.

Mr. ZICKLIN. Or they would put a minimum fee on it.

Mr. OPPER. Would the same hold true for insurance companies.

Mr. GARIL. Yes.

Mr. ROULSTON. Yes.

Mr. GARIL. Even larger in most cases. We have been talking about switching from brokerages to fees. I think there is also a personnel difference which is of great significance. Having built upon your own retail organization, we have had registered reps who have come to us from other firms with accounts, people they have known and worked with for many years. They have had this account, the Widgit Co., or some company that would be covered under 11(a).

This coming May, these people may not be able to continue that relationship even if we decide to charge a fee because it would not be a brokerage account anymore. It would now become an investment advisory account. It would not be exempt from the Investment Advisors Act as it is today. It would have to be structured differently. The responsibilities of the individual might be very different. You would have to go to that account and say, "I am sorry. You can no longer deal with your registered rep whom you have had this account with for the last 30 years. You have to deal with the investment advisory department of Oppenheimer or Neuberger & Berman."

In attempting to hire people, they have said, "What are you going to do about this?" If we knew more about 11(a), we could spell this out for these people. We have had trouble hiring them. They go to a firm that has never heard of 11(a), and that firm says, "Oh, no problem. We'll just continue along the way we have." Knowledge in this case has not been bliss. It has been a disadvantage.

It has been a serious problem for us. It is going to be a serious problem for registered reps who are going to find on May 1 that they are going to lose a good portion of their income to another segment of the firm or, even worse, another segment of the investment advisory community or banking community.

Mr. OPPER. Could that be alleviated by having the registered reps register individually as investment advisers?

Mr. GARIL. That may be one of the things we have got to do. But certainly it can't be done in the next 2 months.

Also, it would raise the other problem. Where he is dealing with a natural person, he would be part of the brokerage organization. When he is dealing with a nonnatural person, he has to be part of the advisory organization. Two sources of income. Two corporations. Double social security tax burden. All of these problems have not been resolved. I don't think they are soluble within the next 2 months.

Mr. ZICKLIN. Most of us are small enough to fit any category. We can manipulate ourselves. But even if we manipulated ourselves to

fit a set of rules on May 1, and we don't know what they are at the moment, we have got a national market system coming in, in the next year. I don't think anyone in this room, certainly no one at this table, would like to make a large bet as to what that system looks like, what you are able to do, what you are not able to do. We may have to evolve again to fit the system. I don't know that it is logical to have us change our businesses, then bring on the national market system and then rechange our businesses if they still exist.

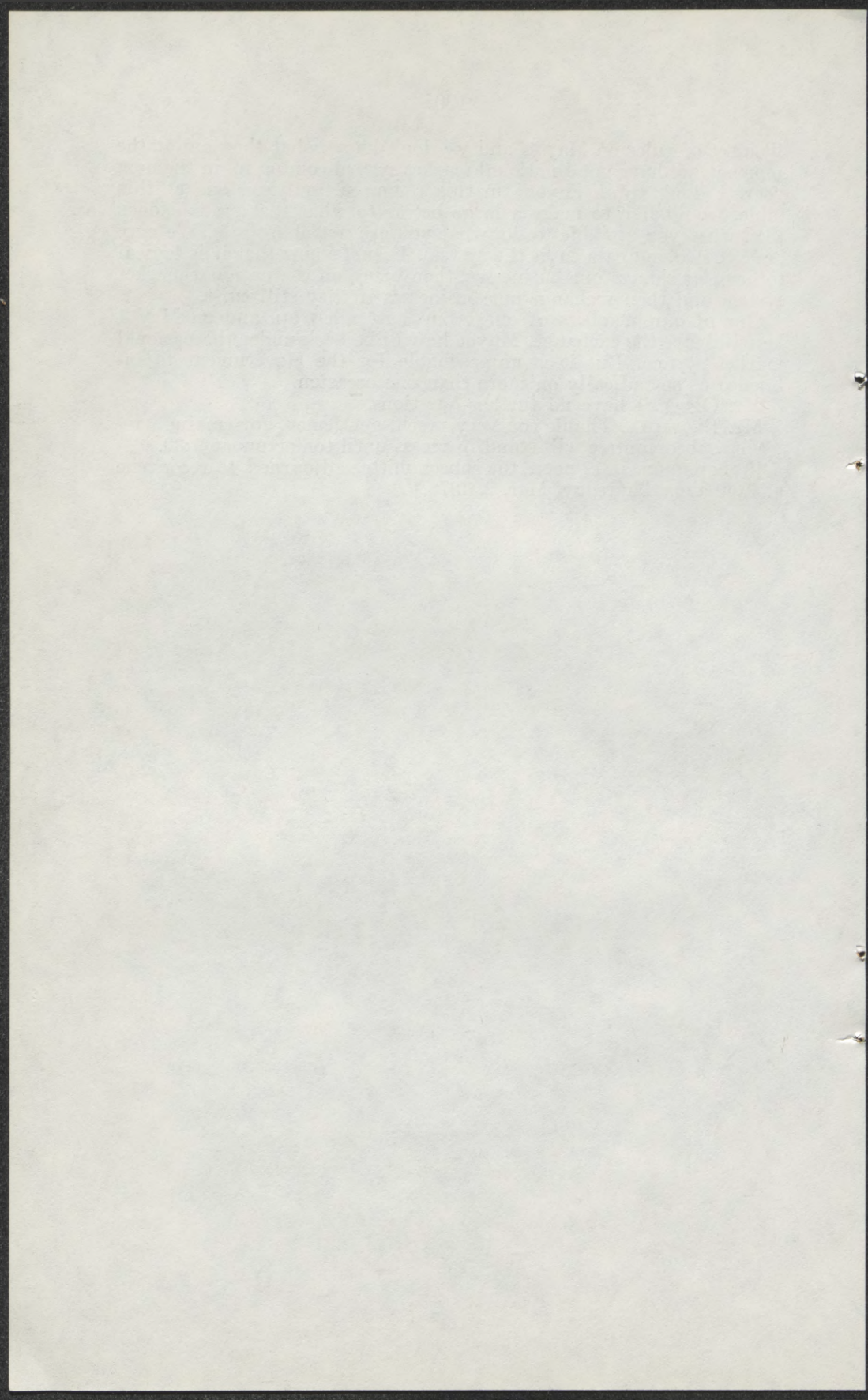
One of our members of our group has called up, and on May 1 he will leave the exchange. Maybe he will be back under the national market system. But it is unreasonable for the Government to influence us so radically on more than one occasion.

Mr. OPPER. I have no further questions.

Mr. BROYHILL. Thank you very much, gentlemen, for coming.

The subcommittee will stand in recess until tomorrow at 9:30.

[Whereupon, at 12 noon, the subcommittee adjourned, to reconvene at 9:30 a.m., Thursday, Mar. 2, 1978.]



SECURITIES AND EXCHANGE COMMISSION— AUTHORIZATION

THURSDAY, MARCH 2, 1978

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 9:30 a.m., pursuant to notice, in room 2218, Rayburn House Office Building, Hon. Bob Eckhardt, chairman, presiding.

Mr. ECKHARDT. The subcommittee will come to order. Will you identify yourself for the record and proceed, Mr. Casey?

STATEMENT OF JOHN L. CASEY, BOARD CHAIRMAN, INVESTMENT COUNSEL ASSOCIATION OF AMERICA

Mr. CASEY. My name is John L. Casey. I am a senior vice president of Scudder, Stevens & Clark, which is a large investment counsel firm. We have offices in several cities including Chicago, Dallas, Houston, and Los Angeles.

I appear here today primarily wearing a hat as chairman of the Investment Counsel Association of America, established in 1937, to develop for investment advisers, standards designed to encourage skilled, unbiased, and continuous investment advice to individual and institutional clients. In order to achieve the lack of bias, there was a rule that there could not be any compensation based on transactions. Most of the firms on whose behalf I speak today are small regional firms with a single office. Many of the offices of Scudder Stevens & Clark could be considered small or regional offices, also.

Our association may have been the first to support a ban on a firm's acting as broker, a dealer, and an adviser. We are aware that section 11(a) is a limited congressional response to self-dealing but we thought of it as a major step forward, and believe today that the SEC, through rulemaking, can make it work, if they will. We have repeatedly opposed the SEC's approach to the issue of institutional membership. The most famous rule was the 80-20 test which was somewhat castigated by this committee in the past. We have disagreed with the efforts of the SEC to bring about institutional membership. We oppose this latest proposal to delay 11(a) and to expand its grandfather clause.

When I got my file out to help on this testimony, I found that our first testimony on the issue had occurred in 1971, and, of course, the issue had been chewed over before that. In rereading it, I find

that the points that are outlined there were points that Congress listened to and found appropriate—in 1974 they acted with respect to ERISA and in 1975 with respect to other institutional accounts. A 1971 statement of George S. Johnston before the SEC is here, and I would appreciate the opportunity to file that in the record, after my testimony.

Mr. ECKHARDT. Without objection, it will be accepted in the record, at that point.

Mr. CASEY. In any event, the SEC did not listen to these arguments and is still trying to undo the proposal and the legislation.

In the file, I found this little clipping from the New York Times, February 4, 1977, which says: "SEC Weighs Move To Undo Law Barring Firms as Dual Advisers." The headline turned out to be prophetic. It also tends to be prophetic in the way that 11(a) tends to be distorted—the myth that 11(a) firms, from being both in the business of investment advice and in the business of brokerage, which, as we know, it doesn't. Even though a small number of firms are affected, it is clear that they can still stay in both the brokerage and advisory business.

It is also clear that the revenues of the brokerage industry, as a whole, would not be changed. Why should we support 11(a)? Isn't it better for our members to be able to say—over there are the brokers with their conflicts of interest, but here is this pure group without conflicts of interest? If that is a new business advantage, it is one that rubs against the grain of a professional association, and we are prejudiced in the favor of 11(a) because it rests on the same set of business ethics in which our members founded their firms. That is a real life answer as opposed to a theoretical one. We realize that investment advice can be skilled and continuous whether or not compensation is transaction oriented, but we don't see how advice can ever be unbiased, if compensation is on a transaction-by-transaction basis. The best investment advice will often be to stand pat, make no changes in investments, and that would be uncompensated if transactions were the key. None of our members and none of their affiliates are allowed to earn commissions or spreads as brokers, dealers or investment bankers, for their advisory clients or anyone else.

Our concern about conflicts of interest is hardly unique. The SEC often avoids conflicts as well. Why, a few days ago they came out with proposals to bar or limit the payment by advisers to brokers of finders' fees. That relationship of broker and adviser seems to have far fewer conflicts than institutional membership, and it is a little hard to see the concern about finders' fees of conflicts on the one hand and the move for institutional membership on the other.

In the January 1976 issue of the Business Lawyer, there is a series, there is an article entitled called "Finders Fee Compensation to Brokers and Others," which includes a number of quotations of the SEC about its concern on this conflict of interest, which I will submit to your counsel. In light of that high moral position, we might have expected the SEC to endorse 11(a) enthusiastically. Why does the SEC dislike 11(a)? Why has it continuously opposed this solution? In my judgment, the only answer is, many of the staff

want to increase competition for brokers by removing their institutional clients and pressuring banks and insurance companies into institutional membership. This would certainly increase competition for brokers. But institutional membership in the national market system is self-dealing and involves very serious consequences and very great potential for harm, at least, in our judgment. That is a factor which would affect the markets and affect our status as representatives of our clients as consumers rather than participants in the market system. We think 11(a) was part of a wise design to restore public confidence in the fairness of the markets, and that it shouldn't be tampered with.

We think Congress, when they settled the institutional membership debate by enacting 11(a) did so in the light of the prospect that self-dealing problems could become more, not less, serious after free access was guaranteed. The obvious conundrum is and was, how could commissions be self-negotiated fairly, and we don't think it is possible to negotiate with yourself.

As to the specific proposals of the proposed legislation, they are much less simple than the change in dates. The release seems clear. First, the SEC asks for 18 months more, and then suggests that institutional membership be induced by the disingenuous extension of the grandfather clause to all comers through November 1979. In support of this bit of slight-of-hand they point to potentially negative results on certain firms doing advisory and brokerage business. They then make a bionic leap and indicate that as they read 11(a), exchange members would have to divest themselves of their investment management business. I find that leap an effect done with mirrors. Of course that trick is to define the words "effect transactions" beyond what anyone thought. That is what the SEC did. If you or I call a broker and say "please buy 100 General Motors for my sister's account," that is "effecting" a transaction? Nonsense! Yet, that is what the SEC has said. You rejected that reading in your report last fall after the Oversight Hearings. The SEC in its presentation now characterizes your definition as a new "third view"; we disagree. It is not simply a third view and it is not new. Yours is the only reasonable view and one grounded in the legislative history. How can the agency have the gall to use as a reason for delay that it disagrees with the Congress on a view?

The SEC also says it lacks rulemaking authority "sufficient to eliminate the ambiguities it sees in the word 'effect'." The Commission does have authority under section 11(a) to grant "additional exemptions consistent with the purposes of the section, the protection of investors, and the maintenance of fair and orderly markets." And in fact, the Commission has published for comment proposed rule 11a2-2 under section 11(a) which does embody the interpretation of the terms "effect" recognized by this subcommittee in its oversight report. So it knows it has rulemaking power. That rule 11a2-2 would make it clear that section 11(a) does not prohibit an exchange member, acting an investment manager for a managed account, to initiate an exchange transaction through other members and sets out certain conditions. The proposed rule has been outstanding for almost a full year. Unlike other section 11(a) rules

proposed by the Commission, this rule was generally supported by the commentators, and the criticisms could be easily taken care of, if there were a will.

Finally, the report asserts that full implementation of section 11(a) will be particularly severe on regional and small member firms. As I indicated, most of our 70-odd members are small regional advisers who do no brokerage. They are concerned about the health of regional broker-dealers. But we find it confusing to hear the SEC statement. Our members are viable without brokerage revenues and underwriting commissions. Why should the economics differ for the regional brokers who are advisers, especially as they could continue in both businesses and could indeed do brokerage for all but their managed institutional advisory clients? As I said, we find this confusing. But if the SEC's concern is based on fact rather than rhetoric, the SEC can exercise its current rulemaking power to exempt discretionary institutional accounts of less than a specified dollar amount, say \$150,000.

The Commission has attempted to justify its request for a delay in implementation on the basis of two concerns. One is its own controversy over the meaning of the word "effect." The other basis involves certain adverse consequences it claims might result from the operation of section 11(a). If a delay is approved, however, the Commission does not intend to use that time to resolve either the interpretative problem or the possible adverse consequences. The Commission's stated objectives clearly demonstrate that it wishes the delay in order to prepare for yet another battle next year to repeal the section.

There is no justification for further study and no justification for further delay. Thank you.

[Mr. Casey's prepared statement follows:]

STATEMENT OF JOHN L. CASEY, BOARD CHAIRMAN, INVESTMENT COUNSEL
ASSOCIATION OF AMERICA

My name is John L. Casey. I am Senior Vice President-Law of the investment counsel firm of Scudder, Stevens & Clark with offices in principal cities of the United States and Canada, including New York City, Boston, Houston and Dallas.

I appear here today as Chairman of the Board of the Investment Counsel Association of America. Since 1937, the Association has served as the professional organization for investment advisers registered under the Investment Adviser's Act of 1940. We have approximately 80 members which are widely dispersed in various localities and regions of the United States. All of our members are primarily engaged in rendering investment management services to individual and institutional accounts.

The Association supports the Congressional mandate in Section 11(a) of the Securities Acts Amendments of 1975¹ to prohibit institutional money management and exchange brokerage functions for their managed institutional accounts. It opposes as entirely unjustified the Securities and Exchange Commission's proposal to delay implementation of this section.

The Commission's asserted concern over the impact of such implementation is based upon a sweeping interpretation of Section 11(a) which has never been supported by a fair reading of legislative history and has since been repudiated by this Subcommittee. Its proposal to delay implementation reflects nothing more than stubborn unwillingness to implement a Congressional mandate which it has opposed strenuously and unsuccessfully from the outset of the Congressional deliberations which led to its enactment.

¹ Pub. L. No. 94-29 (June 4, 1975) ("1975 Amendments").

The SEC's unwillingness to implement Section 11(a) is particularly unjustified in view of the careful and prolonged consideration given to this legislation by this Subcommittee in the hearings which led to enactment of the 1975 Amendments to the federal securities laws. The Association appeared on two occasions at those hearings in support of an enactment such as Section 11(a) and in opposition to institutional memberships. We supported Section 11(a) then, and we continue to support it now because it represents legal and regulatory recognition of a fundamental ethical principle which has guided Association members for over 40 years.

As this Subcommittee may know, Association members do not commingle investment management and brokerage business as a matter of professional principle. Thus no member of the Association is a member, or affiliated with a member, of an exchange, and none receives revenues based on the value or frequency of transactions executed for its clients or for any other persons.

We adhere to this principle because the combination of brokerage and money management creates undesirable conflicts of interest which carry a serious potential for harm to clients, to the investment management profession, and ultimately to the securities markets themselves. We are not alone in this concern. The Commission in the last two years also has indicated its concern over whether investment managers performing other services for their clients are acting in accordance with their fiduciary duties.² We also believe that serious impairment of public confidence could result from public investor concerns over institutional domination of the securities markets arising from the use of exchange facilities for the private transactions of institutions.

To deal with these multifaceted regulatory concerns, Section 11(a) prohibits, subject to various exceptions, an exchange member from effecting transactions on that exchange for its own account, the accounts of its associated persons, and its managed institutional accounts. There has been a great deal of rhetoric by those who objected to the Congressional approach in Section 11(a) from the time it was first the subject of legislative hearings. But the fact remains that Congress settled the debate. It determined that certain problems would grow more, not less serious, after free access for qualified broker-dealers to securities exchange membership was guaranteed and that Section 11(a) is the best way to resolve those problems.³

In the letter transmitting the legislative proposal, however, the Commission argues to this Subcommittee against "full implementation of the trading prohibitions of Section 11(a) on May 1."⁴ The Commission claims that "full implementation" at this time will "impede achievement" of the competitive goals established by other provisions of the 1975 Amendments, prompt members to leave exchanges, interfere with the evolution of the national market system, and create impossible enforcement problems. For these reasons, it urges that this Subcommittee authorize not only an 18-month delay of "full implementation" but also the repeal of the existing application of Section 11(a) to member firms which joined exchanges after May 1, 1975. Thus, the Commission uses a concern over "full implementation" to seek complete repeal of the provision which Congress adopted after rejecting the Commission's 80-20 Rule and which the Commission has always opposed and has failed to implement in a fair and reasonable way.

The Commission's claim of potentially serious effects from the "full implementation" of Section 11(a) rests upon an interpretation of the term "effect" in that section which could require all exchange members to divest themselves of their money management businesses. Such a "sweeping" interpretation, however, is unsupported by legislative history. As this Subcommittee has pointed out to the Commission, Section 11(a) merely requires that member firms not execute or receive benefits from the execution of exchange brokerage

² See, for example, Sec. Exch. Act Rel. No. 13029 (Dec. 2, 1976), in which the Commission proposed rules governing the contents of disclosure required to be given by advisers which sell securities to or purchase securities from their clients. See also Inv. Co. Act Rel. No. 9915 (Aug. 31, 1977) in which the Commission cautioned investment advisers and management of investment companies about the use of mutual fund assets to finance the distribution of their shares.

³ See Section 6(b)(2) of the 1934 Act, which, as amended by the 1975 Amendments, prohibits the registration of an exchange as a "national securities exchange" unless the Commission determines, among other things, that its rules provide free access for qualified broker-dealers.

⁴ Letter and accompanying memorandum of the Securities and Exchange Commission to the U.S. Congress, dated February 22, 1978 (hereinafter "SEC Letter" and "SEC Memorandum", respectively).

orders generated by the institutional accounts they manage.⁵ Thus, Section 11(a) mandates only the separation of money management and brokerage functions with respect to any one institutional account.

The Commission overstates the impact of Section 11(a). As properly interpreted, this section does not require divestment of money management businesses or even reduce brokerage industry revenues. It merely requires that exchange members not profit from the captive brokerage orders that they generate on certain of their managed accounts. By requiring that such captive orders be effected by independent brokerage firms, Section 11(a) enhances the forces of competition in the brokerage industry rather than impedes them.

In the context of the competitive rate era, the impact of Section 11(a) on the profitability of any particular firm should not be significant. Such firms presently have a duty to charge competitive rates to their managed accounts. If they are properly discharging that duty, their brokerage businesses should be competitive and not dependent on brokerage from captive accounts. To the extent that is not the case, it only demonstrates the need for Section 11(a).

The Commission's expression of concern over the impact of Section 11(a) on the brokerage industry is particularly disingenuous. It has never allowed that concern to interfere with its vigorous support of competitive rates—a step which, unlike Section 11(a), had a substantial impact on industry revenues. It now sees fit to highlight that concern where the impact of change is far less significant. Thus, the Commission uses the spectre of harm to brokerage firms as a basis for its opposition to implementation of the legislative will.

II. THE CONGRESS SHOULD NOT SANCTION THE SEC'S UNWILLINGNESS TO IMPLEMENT THE CONGRESSIONAL MANDATE OF SECTION 11(a)

The Commission attempts to support its proposal to postpone the enactment of Section 11(a) by claiming that it has been unable to resolve the "controversy" as to its requirements and purposes. It points primarily to the "disagreement that has arisen over the meaning of the term 'effect'" and claims that this "disagreement demonstrates the difficulty of insuring that Section 11(a), when fully effective will apply . . . in the ways intended by the Congress."⁶

The Commission's statement, however, ignores the fact that such "difficulty" and "controversy" as may exist in the implementation of Section 11(a) are largely of its own making. For example, in January 1976, only shortly after Congress resolved the legislative controversy over Section 11(a) through enactment of the 1975 Amendments, the Commission gave it new life. It saw fit at that time to commence a "public dialogue" by indicating its belief in a "sweeping" interpretation of the term "effect" in Section 11(a). That interpretation would have prohibited an exchange member from even arranging for execution of a brokerage order for a managed account with an entirely independent member. It thus would have forced, as a practical matter, all exchange members with institutional money under management to divest themselves of either their institutional money management businesses or their exchange brokerage businesses.

The Commission responded to the "public dialogue" on its "sweeping" interpretation of Section 11(a) by proposing in 1977, exemptive rules which would have nullified the entire prohibitions of that section against commingling of the money management-brokerage functions. As the Commission's transmittal memorandum indicates, its interpretation and subsequent exemptive rules provoked a "wide spectrum of views and interests" which were reflected in more than 800 pages of written comments.⁷ The Commission then seized upon the "wide spectrum of views and interests" to provide further credibility for its own claims of "controversy" and "difficulty" in resolving ambiguities in the interpretation of Section 11(a).

In its Oversight Report, this Subcommittee considered at length the SEC's "sweeping" interpretation of Section 11(a). It concluded that this "interpreta-

⁵ "Oversight of the Functioning and Administration of the Securities Act's Amendments of 1975," Report of the Subcomm. on Oversight and Investigations and Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce, Comm. Print No. 95-27, 95th Cong., 1st Sess. 10 (1977). ("Oversight Report.")

⁶ SEC Memorandum at 3.

⁷ *Id.* at 2.

tion goes too far".⁸ The Report flatly declared that "such a result was clearly not intended," pointing out:

"Merely arranging for brokerage (as distinguished from actually executing the transaction) is an integral part of the function of managing an account; therefore, to prohibit a member from arranging to have another member perform brokerage for the first member's managed accounts would create such a serious obstacle that the first member would be forced to abandon managing that account, or to withdraw from exchange membership."⁹

The Oversight Report pointed out that "a primary purpose of Section 11(a) was to place broker-dealers with managed accounts on the same footing as their competitors, such as bank trust departments and investment counsel organizations." The report noted that these competitors as part of their money management business arrange for broker-dealers to effect transactions for their managed agents. It concluded that the Congress never intended Section 11(a) to place broker-dealers at a competitive disadvantage. The Oversight Report also noted the Commission's interpretation would have another effect never intended by Congress. It would deprive exchange members of the revenue from managing institutional accounts.¹⁰

The Report concluded that "it is permissible under Section 11(a) for an exchange member to arrange for another member to execute transactions which the first member orders on behalf of an account under its management."¹⁰ It recognized that such activities by brokers with the managed accounts were permissible only if they did not "retain any compensation for making such arrangements."¹⁰ It called upon "regulation and vigorous enforcement action" by the SEC to deal with the "risk that broker-dealers with managed accounts will devise reciprocal practices in an effort to circumvent Section 11(a)."¹¹

The Oversight Report pointed out that "[t]he legislative history of Section 11(a) is replete with statements making clear that that section was not designed to preclude exchange members from handling managed accounts."¹² Indeed, that legislative history shows that as early as 1972 this Subcommittee indicated in its Securities Industry Report that there was no need for legislation forcing stock exchange firms to divest themselves of their institutional money management businesses. The Report stated:

"The Subcommittee finds that there is no necessity to require that broker-dealers choose between the brokerage or the money management business." (Emphasis in original)¹³

The legislative history also shows that the Commission's sweeping interpretation of Section 11(a) was inconsistent with its own statements to Congress on Section 11(a) during the Congressional hearings preceding enactment. At that time the Commission also recognized that the word "effect" had a meaning comparable to the term "execute". Thus, the Commission's statements before this Subcommittee described H.R. 5050 as containing an "approach . . . prohibiting a member from *executing* transactions for any

⁸ Oversight Report at 10.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* at 11.

¹² *Id.* at 10.

¹³ Securities Industry Study, Report of the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, H. Rep. No. 92-1519, 92nd Cong., 2nd Sess. 149 (1972) ("House Study Report"). In its 1973 Securities Industry Study Report the Senate Subcommittee on Securities adopted the same position, stating:

"The way to eliminate almost all of the conflicts would be to prohibit any firm or group of affiliated firms, from engaging in both brokerage and money management. However, the case has not been made for so drastic and disruptive a step. As noted above, there does not appear to be any evidence of widespread abuse. Such a complete separation would also deprive the industry of the relatively steady income available from money management to offset the cyclical nature of the commission business, and would eliminate financial institutions as a source of much needed capital for the brokerage industry. It would deprive pooled accounts of the money management expertise of the securities industry." Securities Industry Study, Report of the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, S. Doc. No. 93-13, 93rd Cong., 1st Sess. 86-87 (1973) ("Senate Study Report").

Subsequently, the full Senate Banking Committee adopted the Subcommittee's views in its Report on S.470, which was printed less than two months after the release of the Study Report. The Report on S.470 describes the bill as containing a "prohibition . . . against an exchange member *executing* transactions for its affiliates or managed, institutional accounts." (Emphasis added). S. Rep. No. 93-187, 93rd Cong., 1st Sess. 15 (1973) ("S. 470 Report").

institutional account which it manages." (Emphasis added).¹⁴ Similarly, four months later the Commission noted in its written statement on S.470 that the bill "would prohibit a member of an exchange from *executing* transactions on such exchange for its own account . . ." (Emphasis added).¹⁵

The same understanding was expressed to the Subcommittee during the extensive hearings on H.R. 5050 by witnesses testifying on behalf of institutions and brokerage firms that provide discretionary investment management services to institutions. Their testimony, like the Commission's, reflects an understanding that the word "effect" would not require separation of the brokerage and money management businesses of exchange members. Thus, Bernard H. Garil of Oppenheimer & Co., in his written statement on H.R. 5050 noted that the bill "provides for a ban on broker-dealers *executing* most orders for affiliated accounts." (Emphasis added).¹⁶

Despite the grounding in legislative history of this Subcommittee's repudiation of the Commission's sweeping interpretation of Section 11(a), the Commission in its transmittal letter and memorandum continues to characterize the Subcommittee's interpretation of Section 11(a) as simply a "third view." Moreover, the Commission claims that it does not have rulemaking authority "sufficient to eliminate" the ambiguities surrounding the meaning of the term "effect".¹⁷ If the Commission's authority is not adequate to resolve these ambiguities, it can only be because the Commission seeks to resolve them in a manner inconsistent "with the purposes of the section, the protection of investors and the maintenance of fair and orderly markets", the standards established by Congress for the exercise of the Commission's Section 11(a) exemptive authority.

In fact, under this exemptive authority the Commission has published for comment proposed Rule 11a2-2 which embodies the interpretation of the term "effect" recognized by this Subcommittee in its Oversight Report. That rule would define the term to permit the section to operate as the legislative history indicates Congress intended. Rule 11a2-2 would make it clear that Section 11(a) does not prohibit an exchange member, acting as investment manager for a managed account, from initiating an exchange transaction through an independent member. The proposed rule has been outstanding for almost a full year. Unlike other Section 11(a) rules proposed by the Commission, this rule was widely supported by commentators. Nevertheless the Commission has failed to take any action to adopt it.

The Commission attempts to excuse its lack of diligence by pointing out that "whatever solution the Commission reaches will not convince all interested parties that the Commission has acted in accordance with their views of the intent of the section or in a way they consider appropriate . . ." ¹⁸ Such a claim comes as a surprise to all those who are affected by this agency's rules. If satisfaction of "all interested parties" were the criteria for the Commission's exercise of its rulemaking authority, the Commission could have adopted few, if any, rules under the federal securities laws. Such an explanation only belies the Commission's claim that it "has made strenuous efforts since enactment of Section 11(a) to provide interpretations" of the meaning of the term "effect."¹⁹

To the contrary, the "strenuous efforts" of the Commission have been to ventilate, not resolve, the controversy and thus to defeat a legislative mandate

¹⁴ Hearings on H.R. 5050 and H.R. 340 ("Securities Exchange Act Amendments of 1973"). Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 93rd Cong., 1st Sess. 457 (1973) ("H.R. 5050 Hearings").

¹⁵ Hearings on S. 470 ("Fixed Rates and Institutional Membership") Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 93rd Cong., 1st Sess., 232 (1973) ("S. 470 Hearings").

¹⁶ H.R. 5050 Hearings at 1583. See also William T. Scott, Executive Director of the New York City Teachers Retirement Fund, who described the prohibition as simply "preventing member firms from doing brokerage business for managed institutional accounts," observing (*Id.* at 1706):

"I am well aware that this section does not prohibit an institutional fund such as ours from retaining a broker as money manager. The prohibition only deals with the commissions that could flow through a broker manager." *Id.* Similarly, Donald Regan, Chairman of the Board of Merrill Lynch, Pierce, Fenner & Smith, Inc., noted that "H.R. 5050 would cost Merrill Lynch the revenue that we now get from the *brokerage* of our investment counseling subsidiary, Lionel D. Edie & Co. . . ." (Emphasis added). *Id.* at 1558.

¹⁷ SEC Letter at 4.

¹⁸ SEC Memorandum at 5.

¹⁹ SEC Letter at 4.

which it has consistently opposed and now is unwilling to implement. We submit that this Congress should not ratify such administrative unwillingness to implement the legislative will by passing this bill.

III. THE REASONS ASSERTED BY THE COMMISSION HAVE BEEN REPEATEDLY CONSIDERED BY THE CONGRESS AND DO NOT JUSTIFY DELAY.

Congress was aware that Section 11(a) "will not provide the perfect solution"²⁰ for all the problems it identified. It recognized, however, that "any suggested remedy that would completely eliminate one problem would exacerbate one of the others or would be so draconian that its burdens would outweigh its advantages."²¹ The range of strongly negative comments filed each time the Commission has rekindled the Section 11(a) controversy should be a clear indication of Congress' wisdom. The Congress laid these issues to rest in 1974 by enactment of ERISA and in 1975 by enactment of Section 11(a). The Commission should not be permitted perennially to resurrect them. This is just what it seeks to do in proposing a delay in the implementation of Section 11(a) and in the expansion of the grandfather clause in that section.²²

A. If the Commission Properly Interprets Section 11(a), Its Implementation Will Have Positive, Not Adverse Effects.

1. Section 11(a), Properly Interpreted, Will Foster, Not Impede, Competition.

In his letter to the Congress, SEC Chairman Williams indicated that the Commission is "dusturbed" over the potential effects of Section 11(a) on competition among money managers during the period when national market system mechanisms are being established.²³ The Chairman stated:

"In that regard, the Commission believes that operation of the section in the context of a developing national market system might impede achievement of the competitive goals established by Section 11A(a) (1) (C) (ii) of the Act."²⁴

Chairman Williams claimed that Section 11(a) will "engender anticompetitive effects that were not, and could not have been, anticipated three years ago."²⁵

To support this claim the Commission argues that negotiated commission rates have eliminated stock exchange membership as a competitive factor in the money management business. Moreover, the Commission claims if Section 11(a) were to become effective, "exchange members, and particularly regional and small members, [would be placed] at a severe disadvantage" and may no longer be competitive.²⁵ As a result, Section 11(a) may "exacerbate the existing trend toward concentration in the securities industry."²⁵

The Commission fails to point out that exchange members will be placed at a competitive disadvantage only if the Commission continues to cling to its interpretation that requires exchange members to divest their institutional money management businesses. If the Commission were to accept the proper interpretation of the word "effect," broker-dealers, including small broker-dealers and regional firms, would not be placed at a competitive disadvantage. They would be in no different a competitive position than any other similarly situated national and regional money managers, including the many regional money managers which are members of our Association. It is only the Commission's refusal to accept the proper interpretation of the word "effect" that has created the possibility of harm to small and regional firms.

If the Commission accepts the proper interpretation of the word "effect", any dislocation which might occur as a result of the implementation of Section 11(a) will be insignificant. There will be no general loss of brokerage commission revenue to exchange members as a group. Certain members will lose the captive brokerage business of institutional accounts which they manage. These firms, however, will be able to compete for the brokerage business of institutional accounts managed by other exchange members which are also affected by Section 11(a). If those firms provide quality service at

²⁰ Senate Study Report at 86.

²¹ *Id.*

²² See Section 406 of the Employees Retirement Income Security Act of 1974, Pub. L. No. 93-406 (September 2, 1974) ("ERISA"), and Section 4975 of the Internal Revenue Code of 1954, as amended.

²³ SEC Letter at 2.

²⁴ *Id.*

²⁵ *Id.* at 3.

competitive prices, they should be able to attract the brokerage business of institutional accounts managed by others. Thus, Section 11(a) would actually foster additional competition in brokerage services.

In the present negotiated rate environment, institutional brokerage commissions should not be a high profit margin operation. Institutional commissions are highly competitive. Thus, any brokerage business that an individual firm loses from institutional accounts should not have a significant impact on its profitability. And in many cases, this can be offset by business received from other brokers affected by Section 11(a).

More importantly, if the loss of brokerage commission profits from its managed institutional accounts does jeopardize the viability of a brokerage firm, then the rates being charged by that firm and the quality of its execution services become questionable. Ironically, it is just this situation that demonstrates the subtle but substantial potential for abuse that this Subcommittee's Securities Industry Study found exists in the combination of money management and brokerage.

Moreover, any delay in the effective date at this point in time will be at the expense of those firms that have acted in good faith to operate within the constraints of Section 11(a). Many brokerage firms that will be affected by Section 11(a) have for ethical, legal or business reasons already adjusted their businesses in anticipation of May. A few firms have actually divested themselves of a large portion of their institutional money management accounts. Presumably, Section 11(a) was an important, if not a principal factor in those firms' decision to divest. Many other firms have altered their relationships with institutional clients to avoid contractual provisions that would make the accounts "discretionary accounts", as that term is defined in the 1934 Act. Still other firms have made large investments to enhance their competitive capability to replace captive brokerage business with unaffiliated business.

The Commission asserts, however, that the effects of Section 11(a) will be particularly severe on regional and small member firms because these firms already are vulnerable as a result of the elimination of fixed rates. But, as the Commission itself noted in its 1977 Report on the Effects of the Absence of Fixed Rates of Commissions regional firms were affected relatively lightly by negotiated rates. The Report states:

"Fluctuations in the financial data of the Regional/OTC firms primarily reflect movements in market conditions. Negotiated commission charges do not appear to have seriously impaired the operating performance of this group. To the extent these firms rely more heavily than NYSE members on non-exchange transactions, the impact of negotiated commissions appears to have been less for them than for their NYSE counterparts."²⁶

The Commission's 1977 Report, moreover, made it clear that the real impact of negotiated rates has been on the small segment of the industry generally referred to as "institutional firms." In his transmittal letter for the Report, then Chairman Roderick Hills noted that it had been these firms "which have suffered the greatest revenue impact."²⁷ The Association is not aware of any changes since that Commission report which would affect those conclusions.

Thus, the attempt to justify delay in the implementation of Section 11(a) as necessary for the health of the securities industry is nothing more than the "institutional subsidy" argument used by the Commission in 1972 to support its "80-20" approach to resolve institutional membership problems. The Congress rejected this argument then and again rejected it each time it was made by members of the brokerage industry opposed to Section 11(a). The Congress should not accept it now to justify further delays in implementation. As this Subcommittee itself noted with respect to Section 11(a), "the argument that the section will cause great disruption to the securities industry . . . is a somewhat anomalous concern at this point, since the securities industry itself was largely responsible for the inclusion of the section in the 1975 Amendments."²⁸

2. Section 11(a), Properly Interpreted, Will Support, Not Adversely Affect, Implementation of the National Market System.

If the Commission interprets the word "effect" properly, Section 11(a) will not interfere with steps taken by the Commission to implement the national

²⁶ Securities and Exchange Commission, Fourth Report on the Effect of the Absence of Fixed Rates of Commissions, p. 41 (January 28, 1977).

²⁷ *Id.*, Transmittal Letter at p. 4.

²⁸ Oversight Report at 9.

market system. On the contrary, the legislative history demonstrates the Congress has determined that Section 11(a) is necessary to foster the development of the national market system. One purpose of the section is to assure that the evolution of the national market system is not adversely affected by artificial incentives for exchange membership.

The Senate Banking Committee indicated as early as 1973 that it believed there must be a "flexible movement toward the creation of a new central market system without undue attachment to current patterns."²⁹ The experience of the 1960's and early 1970's provided ample evidence to demonstrate that there is a strong inducement for exchange members to direct order flows to the exchanges where they have the lowest execution expense. Not only can this result in a failure to obtain best execution; it can cause fragmentation of the securities markets.

The Congress determined that distortions similar to those that occurred in the 1960's would be likely to result after the 1934 Act was amended to provide for unlimited access to all exchanges. It concludes that, without prohibitions such as those in new Section 11(a), the "natural evolution" of a central market system that it desired would not be possible.³⁰

Congress also believed that separation of brokerage from the management of institutional accounts would have a related beneficial effect. It was aware of concern over what one industry leader, William Salomon as the "great-test potential problem presented by the combination of money management and brokerage" in a negotiated rate environment.³¹ With the elimination of the fixed commission rate schedule, exchange members who perform brokerage functions for their managed accounts are faced with the impossible task of negotiating commissions with themselves. As the Senate Report on S. 249 concluded, the combination of money management and brokerage "could distort the natural evolution of the markets. Where functions are separated, institutions are customers for securities market services. As such, they will seek the most efficient and flexible market relationships, and thus help to sharpen price and service competition in the securities business. If the institutional money managers are also the brokers, however, they will lose a good deal of their incentive to bargain with the brokers on behalf of their beneficiaries. . . ." ³²

The problems associated with the evolution of the central market system and negotiated commissions are particularly institutional problems. They are not as likely to occur with managed accounts of individuals. Congress recognized that only institutions, as a class, engage regularly in securities transactions of a size and frequency that can cause distortions in the evolution of securities markets.³³ Moreover the very fact that institutional orders are much larger and potentially more profitable was perceived by the Congress to be a cause of the individual investor crisis. Thus, Section 11(a)'s approach at the same time eliminates both a source of interference with the natural evolution of the securities markets and a principal cause of the individual investor crisis.

Congress also understood that the negotiated rates would not impact individual investors to the same extent as institutions. It realized that, for the most part, individual investors would continue to pay commissions according to schedules and would not be in a position to negotiate.³⁴ In contrast institutions, as a class, tend to generate transactions of a size and frequency that would involve substantial negotiations between the broker and client.

3. Section 11(a), Properly Interpreted, Will Not Create A Significant Incentive For Avoidance.

The Commission claims that implementation of Section 11(a) is likely to "distort the ways in which members conduct business."³⁵ It argues that the section could cause members "which depend heavily on brokerage generated by accounts they manage" to resign their memberships in order to avoid the impact of Section 11(a).³⁶

²⁹ S. 470 Report at 14.

³⁰ H.R. Rep. No. 93-1476, 93d Cong., 2d Sess. 53-54 (1974) ("H.R. 5050 Report"); H.R. Rep. No. 94-123, 94th Cong., 1st Sess. 49-50 (1975) ("H.R. 4111 Report"); S. Rep. No. 94-75, 94th Cong., 1st Sess. 65 (1975) ("S. 249 Report").

³¹ S. 249 Report at 65.

³² *Id.*

³³ *Id.* at 64; S. 470 Report at 9.

³⁴ H.R. 5050 Report at 118.

³⁵ SEC Memorandum at 10.

³⁶ *Id.* at 9.

The Commission's claim that many exchange members rely heavily on brokerage profits from managed institutional accounts appears directly inconsistent with its claim that Section 11(a) will have anticompetitive effects. In support of that claim, the Commission stated that institutional commission rates are so low that there is no longer a profit incentive to join an exchange. If institutional rates are in fact that low, it is difficult to understand how there can be many exchange members "which depend heavily on brokerage generated by accounts they manage" for their viability. If such members do exist, however, it is questionable whether the commissions they charge their managed institutional accounts have been fairly negotiated.

If this concern had been overlooked or ignored by Congress, the Association would understand the Commission's concern. But it was not overlooked or ignored. Both the House Commerce Committee and the Senate Banking Committee recognized in their Reports that in a negotiated rate environment Section 11(a) could "create important disincentives to exchange membership."³⁷ It was understood that, in order to avoid the prohibition against commingling brokerage and money management, members might leave exchanges or funnel orders into the third market.³⁸

To prevent abandonment of exchange membership to avoid Section 11(a), the Commission was given additional authority in new Section 11(a)(2) to "regulate or prohibit" transactions not covered by the prohibitions of Section 11(a)(1). The Commission's rulemaking authority under this paragraph extends to transactions on or off exchanges by members and non-members. It applies to transactions for any managed account and to transactions (except market-maker or odd-lot transactions) for the account of a member or non-member or an associated person. To exercise that authority and extend the prohibitions of Section 11(a)(1) to all transactions for institutional accounts it need only find that such action is "necessary or appropriate in the public interest and for the protection of investors, to maintain fair and orderly markets, or to assure equal regulation of exchange markets and markets occurring otherwise than on an exchange. . . ."

Moreover, the Association believes there is a common failure found in the statements of those who express a concern that Section 11(a) will result in firms resigning from exchanges. Although a number of persons have stated this concern, none has produced evidence that resignations are occurring or are likely to occur as a result of Section 11(a).

4. Section 11(a), Properly Interpreted, Will Not Create Enforcement Problems.

The Commission claims that "Section 11(a) presents substantial enforcement problems."³⁹ One of those problems, the Commission admits, has been created by its controversy over the meaning of the word "effect." It claims that its own enforcement efforts "may be severely hampered by parties who choose to litigate some of the Commission's interpretations of Section 11(a)."⁴⁰ Rather than induce litigation over clearly improper interpretations of the word "effect," the Commission should follow the Oversight Report's mandate to exercise its rulemaking authority and adopt the correct interpretation.

The Commission also argues that Section 11(a) may lead certain members to engage in reciprocal brokerage practices. This is not a new concern. The Commission has expressed it many times before the Congress. As the Oversight Report stated, the possibility of reciprocal practices "... was recognized as early as 1972 in the report of the then Subcommittee on Commerce and Finance. Now, as then, the Subcommittees intend to rely on regulation and vigorous enforcement action by the Securities and Exchange Commission to prevent such reciprocal practices."⁴⁰

In view of this clear statement of Congressional purpose, it is surprising that the Commission continues to assert the possibility of reciprocal practices as a reason for delaying the implementation of Section 11(a). The Congress has weighed this concern of the Commission. It has determined that, on balance, the combination of money management and brokerage functions present potentially greater problems. The Commission's persistent refusal to accept this policy decision only adds to the controversies that surround all of its actions concerning Section 11(a).

³⁷ H.R. 4111 Report at 73.

³⁸ *Id.*

³⁹ SEC Memorandum at 10.

⁴⁰ Oversight Report at 11.

B. None of the Commission's Stated Purposes Are Related to its Reasons for Delay.

The Commission has attempted to justify its request for a delay in implementation on the basis of two concerns. One is its own controversy over the meaning of the word "effect." The other basis involves certain adverse consequences it claims might result from the operation of Section 11(a). If a delay is approved, however, the Commission does not intend to use that time to resolve either the interpretive problem or the possible adverse consequences. The Commission's stated objectives clearly demonstrate that it wishes the delay in order to prepare for yet another battle to repeal the section.

The Commission indicates that the 18-month delay will give it an opportunity "for further study of the problems presented by the section in the context of the altered market environment in which the section finally would become fully effective."⁴¹ Thus, by this legislative proposal, the Commission is requesting Congressional authority for yet another study of Section 11(a). It apparently is not enough that this section was the subject of two Congressional Securities Industry Studies, two extensive legislative programs by the Congress, and the more recent review by this Subcommittee and the Oversight Subcommittee. The Commission now intends to embark on yet one more study with no indication that it would produce results more fruitful than those which produced the "80-20" Rule.

There is no justification for further study and no justification for further delay. It is time to implement Section 11(a) and to proceed with resolution of today's problems affecting the development of the national market system. A fixation on yesterday's problems can only impede that development.

In its memorandum the Commission also states that another purpose for the delay is to allow exchange members additional time "to make appropriate adjustments in their business practices."⁴² This additional time to adjust is necessary, according to the Commission, because the controversy over the "scope and application of Section 11(a)" has prevented many exchange members from making any adjustments.⁴²

The Commission gives no indication whatsoever, however, how many such firms exist. Nor does the Commission indicate whether any firms have actually requested a delay for this particular reason. In addition, the Commission fails to point out that there are many firms which have made adjustments in their business operations. To permit other exchange members to continue to disregard Section 11(a) for another 18 months would only penalize those exchange members which have conscientiously attempted to comply with Section 11(a).

IV. THE COMMISSION'S REQUEST FOR DELAY FAILS ENTIRELY TO ADDRESS THE CONCERNS THAT LED CONGRESS TO ENACT SECTION 11(a).

Section 11(a) is a complex response to a number of different problems. In part, Section 11(a) embodies the Congressional solution to difficult and controversial issues raised by the question of institutional membership on exchanges. In this respect, Section 11(a) reflects Congress' acceptance of the fundamental principle that the securities markets should serve public, not private purposes, a principle first articulated by the Commission in its Statement on the Future Structure of the Securities Markets.⁴³

In addition, Section 11(a) reflects Congressional concern over several different types of conflicts of interest in the combination of money management and brokerage for the same institutional account. As previously indicated⁴⁴ since certain of these conflict problems could impede the evolution of a national market system, the concern over them reflects a Congressional desire to assure there will be no artificial interference with that evolution.

Opponents of Section 11(a) often attack the concern over conflicts of interest by attempting to isolate and minimize them one by one. The legislative history of the 1975 Amendments, however, fully demonstrates that it was the combination of those conflicts which concerned Congress, that in many respects they are substantially more serious for managed institutional accounts than individual accounts and that they clearly justify Section 11(a).

⁴¹ *Id.*

⁴² SEC Memorandum at 11.

⁴³ Securities and Exchange Commission, "Statement on the Future Structure of the Securities Markets," (Feb. 2, 1972) ("Future Market Statement").

⁴⁴ See pages 21-23, *supra*.

A. The Commission's Request Ignores the "Public Purpose" Principle Established in Section 11(a) to Restore Individual Investor Confidence in the Securities Markets.

A principle purpose of Section 11(a) is to restore individual investor confidence in institutionally dominated securities markets. Section 11(a) was adopted to accomplish this because unrestricted institutional access to exchange floors was perceived as a principle source of individual investor's disillusionment with the markets.

Thus, by adding new Section 6(b) to the 1934 Act, Congress makes it clear in the 1975 Amendments that discriminatory or anticompetitive restrictions on exchange membership are not to be permitted. Any qualified broker or dealer, including an institution, now can become an exchange member regardless of its principal business. Congress mandated the "public purpose" requirement of Section 11(a) because it recognized the harm to individual investor confidence and the evolution of the securities markets that could result from such unrestricted institutional use of exchange membership.

Congress also recognized that problems of institutional domination and restoration of individual confidence required other restrictions as well. Thus, the full House Commerce Committee Report on the 1975 Amendments discussed the significant increase in institutional trading in recent years and the impact on price fluctuations of institutional activity in large blocks of securities. It emphasized that just as important as the actual impact is the fact that "significant numbers of investors believe that the institutions . . . gain unfair advantages in the marketplace."⁴⁵ The Committee also found that "the growing tendencies to institutional membership on securities exchanges" has "significantly exacerbated" the problems.⁴⁶

The Committee Report emphasized "the need for giving the Commission expanded regulatory authority to eliminate unfair trading advantage and assure public investors the best opportunity for fair treatment in our trading markets." The Report noted that when the 1934 Act first was adopted, the on-floor member had the greatest advantage. It concluded that with the development of better communication networks, the off-floor trader had similar informational and market proximity advantages, such as faster execution capability and better "feel for the market."⁴⁷

The Committee was aware that the relative advantages of exchange membership should dissipate as greater numbers of broker-dealers have access to the better communication networks. Nevertheless, the Committee decided that "the restoration of investor confidence in our securities markets" requires legislation that assures public investors that "trading by professional participants in the market is fair and without preference or advantage" and that they will be able to trade "on an equitable basis" with professional investors.⁴⁸

B. The Commission's Request Ignores the Conflicts of Interest which Congress Found Would Justify Section 11(a).

In enacting Section 11(a), the Congress also was concerned with a number of different types of conflicts of interest that result from the combination of brokerage and money management functions, "such as churning, choice of market, appropriate commission level and dumping." Two of these conflicts, "churning" and "dumping", are not new. They have always been present in individual as well as institutional accounts when an adviser has discretionary authority to buy or sell securities for a client.

For this reason, some persons have questioned the exclusion from the prohibitions of Section 11(a) for transactions effected "for the account of a natural person." The Commission also raised this issue in the hearings on the 1975 Amendments and sought to use that exclusion in 1977 as justification for its proposed broad exemptive rules which would have virtually nullified the application of Section 11(a) to institutional accounts. The Commission on these occasions expressed the view that logical consistency requires that individuals be treated the same as institutional beneficiaries.

⁴⁵ *Id.* at 56. See also testimony of Robert W. Haack, President of the New York Stock Exchange, and colloquy between Mr. Haack and Senate Securities Subcommittee Chairman Harrison A. Williams, Jr., Hearings on S. 1164 and S. 3347 ("Institutional Membership on National Securities Exchanges") Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92nd Cong., 2d Sess. 370-371 and 377 (1972).

⁴⁶ *Id.*

⁴⁷ *Id.* at 55.

⁴⁸ *Id.*

The Congress, however, rejected that argument. It found that a different treatment was appropriate because of "important distinctions between institutional and individual accounts".⁴⁹ The Senate Subcommittee explained:

"Because individuals receive detailed current information about their accounts, unlike the beneficiaries of pooled accounts who receive at best only the most summary reports of their portfolio transactions, individuals are in a better position to protect their interests than the beneficiaries of pooled accounts. Congress has previously recognized this distinction, and voiced its concern for the beneficiaries of pooled accounts, in the Investment Company Act of 1940 and the recent amendments strengthening that Act."⁵⁰

Thus, the Congress concluded that churning is an especially serious conflict problem for managed institutional accounts because of the greater profitability of their transactions. Moreover, the elimination of fixed commission rates could aggravate rather than ameliorate the institutional churning potential. As the profit margins on brokerage transactions are reduced, there may be an even greater incentive for a brokerage firm to increase its volume of transactions in order to maintain order flow. And a large institution produces the kind of order flow that can easily have a material impact on revenue.

"Dumping" also is a conflict problem with a particularly serious potential for institutions. As every brokerage transaction involves two accounts, a seller and a buyer, a critical factor in generating brokerage business in the institutional securities market is the ability to put together the two sides of a major block transaction. A broker-dealer which does not manage institutional accounts must find both a buyer and a seller and interest each in executing a transaction with the other. In contrast, a broker-dealer which has discretion over an institutional account capable of absorbing a large block of securities need find only one side to the transaction. It already controls the willingness of one side to engage in the transaction at the price demanded by the other customer.

These conflicts do not disappear with negotiated rates. To the contrary, they can be even more serious as they take new forms. For example, unlike in the fixed rate era, the broker-manager in the negotiated rate environment is faced with the conflict of negotiating the brokerage commission for his managed account with himself. It is not surprising, therefore, that Congress considered this conflict not only potentially harmful to the managed account but also to the natural development of a fully competitive central market system.

V. THE COMMISSION'S REFUSAL TO TAKE STEPS TO IMPLEMENT SECTION 11(A) IS PART OF ITS LONGSTANDING BATTLE WITH THE CONGRESS OVER SECTION 11(A).

The Commission's proposed legislation to delay implementation of Section 11(a) is not surprising. This request is just the most recent of many attempts by the Commission to persuade the Congress that its approach to the institutional membership and conflict problems is wrong. It is characteristic of the Commission's attitude toward Section 11(a) from the very beginning.

Section 11(a) in part embodies the Congressional solution to difficult and controversial issues raised by the question of institutional membership on exchanges. It is a solution adopted by the Congress after it rejected the alternative proposed by the Commission's institutional membership rule—the so-called "80-20 Rule." In the view of the Congress, that rule represented "a regrettable chapter in the Commission's generally distinguished history."⁵¹ It found that the rule did "nothing to reduce the conflicts of interest" and "may exacerbate and make more widespread the conflicts which already exist"⁵² from the combination of institutional money management and brokerage.

Consistent with the rationale later underlying the 80-20 Rule, the Commission originally announced in its 1971 Institutional Investor Study Report that the conflicts of interest and other regulatory problems may not require separation of money management and brokerage functions. In that Report the Commission relied on an "admittedly limited analysis of regulatory problems resulting from the combination of management and brokerage functions" to conclude that there was no "unique additional regulatory problems whose severity justifies sweeping prohibitions of such combinations."⁵³

⁴⁹ Senate Securities Industry Study at 87.

⁵⁰ *Id.*

⁵¹ S. 249 Report at 67.

⁵² *Id.* at p. 66.

⁵³ Institutional Investor Study Report of the Securities and Exchange Commission, H. Doc. No. 92-64, Part I, 92nd Cong., 1st Sess. XX-XXI (1971).

One year later in its Future Market Statement, the Commission used this "admittedly limited analysis" to defend its failure to deal with those conflicts in fashioning the 80-20 Rule. It characterized as "valuable" to investors the money management services provided by brokers and considered it "important" that "broker-dealer income be based on a more stable source than commission business."⁵⁴ For this reason, the Commission condemned as "a precipitate measure"⁵⁵ any prohibition against the combination of money management and brokerage activities by exchange members.

The Commission's position was not unanimous. Commissioner Hugh Owens dissented in part. He agreed with the basic position of the Commission that exchange membership should serve public purposes. But he considered that the approach chosen by the Commission to achieve this result was inconsistent and inadequate. Commissioner Owens stated:

"... [I]t is bad for an institution to do business on an exchange through the medium of a broker-dealer affiliate which it controls, but on the other side of the coin, I think that the practice of a broker-dealer performing portfolio brokerage services for institutional accounts which it manages, either directly or indirectly, should likewise be prohibited. I would not include in this category individual discretionary accounts or those belonging to the broker-dealer firm itself or its principals."⁵⁶

Like Commissioner Owens, the Congress accepted the public purpose objective of the Commission but questioned the formula chosen by the Commission to achieve this objective. In light of the "admittedly limited analysis" of the Commission, both the House and Senate authorized their own independent studies.⁵⁷ This Subcommittee and the Senate Securities Subcommittee examined in detail over a period of two years many regulatory problems involved in the combination of brokerage and institutional money management, not just churning. As the Senate Securities Subcommittee announced in its "Interim Report",

"In particular, the Subcommittee will consider whether member firms should be permitted to engage in both money management and brokerage or market making as well as whether they should be allowed to conduct nonsecurities businesses, e.g., insurance and real estate sales."⁵⁸

Both Subcommittees concluded that regulatory problems inherent in the combination of brokerage and money management functions for the same institutional account were serious enough to require legislative action. In its Report, this Subcommittee discussed conflicts of interest and other problems that exist when broker-dealers are permitted to effect transactions for managed institutional accounts. It also discussed the conflicts of interest that would arise when fixed commission rate schedules were eliminated and broker-dealers are called upon to negotiate with themselves over commissions for managed institutional accounts. The Subcommittee concluded that:

"[T]he conflicts are significant enough to warrant amending the Securities Exchange Act to prohibit registered broker-dealers from directly or indirectly performing brokerage transactions for their affiliated accounts." (Emphasis in original.)⁵⁹

Similarly, in its final Report, the Senate Securities Subcommittee discussed at length three separate categories of problems as follows:

"(1) impediments to fair competition between money managers; (2) conflicts of interest; and (3) distortion in the evolution of the central market system."⁶⁰

After concluding that greater incentives for abuse and potential for harm exist when institutional accounts rather than individual accounts are involved,

⁵⁴ Future Market Statement at 22.

⁵⁵ *Id.*

⁵⁶ *Id.* at 27-28.

⁵⁷ The Senate Securities Industry Study was authorized by Senate Resolution 109 on June 21, 1971. An additional appropriation was authorized in Senate Resolution 244 on March 6, 1972. The House Securities Industry Study was conducted as a result of the debate in the House of Representatives that preceded passage of the Securities Investor Protection Act of 1970, Pub. L. 91-598.

⁵⁸ Securities Industry Study, Interim Report of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess. 67 (Feb. 4, 1972).

⁵⁹ House Study Report at 149.

⁶⁰ Senate Study Report at 73.

the Senate Securities Subcommittee adopted essentially the same position of this Subcommittee:

"After extensive consideration of the matter, the [Senate Securities] Subcommittee is of the view that the question of the combination of money management and brokerage should be resolved by prohibiting stock exchange members and their affiliates from effecting any transactions on national securities exchanges for institutional accounts which they manage."⁶¹

The conclusions of the Congressional Securities Industry Studies are the same conclusions as those reached in the separate Congressional studies which led to the prohibitions on combined money management-brokerage functions in ERISA. Indeed, even the Commission stated in its Future Market Statement that the conflicts of interests which it recognized were "inherent in the combination of money management and brokerage" were "a matter to be resolved by Congress."⁶² The Commission also recognized at that time that:

"Only Congress should decide whether or not this potential conflict can continue to be dealt with in the same manner as the other conflicts mentioned above, by a combination of disclosure and enforcement of fiduciary obligations, or whether it is sufficiently troublesome to require separation of the two functions."⁶³

Nevertheless, for the three years preceding the 1975 enactment of Section 11(a), the Commission conducted an intense campaign to persuade Congress to adopt its approach to institutional membership instead of brokerage-money management separation for the same account. For example, at the Senate Securities Subcommittee's 1973 hearings on S. 470, Commissioner Loomis testified for the Commission against separation of brokerage and money management functions for the same institutional account. He tried to persuade the Subcommittee that the Commission's approach to institutional membership in the 80-20 Rule was not "radically different from" the Congress' approach as reflected in S. 470 and that there was no "grave difference" in the two approaches.⁶⁴ The Senate Securities Subcommittee and the full Senate Banking Committee, however, clearly believed the differences were substantial. They rejected 80-20 Rule in favor of the Section 11(a) approach.⁶⁵

Two years later when hearings on S. 249 were held, the Commission no longer argued that there was "no grave difference." Instead, it admitted to having "problems with [the Section 11(a)] approach,"⁶⁶ and requested the Committee to replace the statutory prohibition with flexible rulemaking authority in the Commission. The Commission's request again was rejected, and Section 11(a) was enacted into law.

V. CONCLUSION

Section 11(a) was enacted two and one-half years ago. Exchange members have had nearly 3 full years to make whatever adjustments were necessary to comply with its provisions. The Commission has had ample time in which to identify any unintended effects of the provision and exercise its exemptive authority to ameliorate them. Under these circumstances, to call the present status of the securities industry an emergency situation stretches the meaning of the word "emergency" beyond recognition. For the Congress to accept this rationale and reverse its position on Section 11(a) would constitute abandonment of the principles and concerns that led to its enactment. There is no justification for this abandonment. The Commission still has sufficient time to adopt appropriate interpretations for the implementation of Section 11(a) by May 1. It needs only a firm indication by Congress that no further delay will be tolerated. The Association urges the Subcommittee to furnish that indication promptly.

Mr. ECKHARDT. Mr. Bunce.

⁶¹ *Id.* at 85.

⁶² Future Market Statement at 23.

⁶³ *Id.*

⁶⁴ Hearings on S. 470 ("Fixed Rates and Institutional Membership") Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 93rd Cong., 1st Sess., 18-19 (1973). ("S. 470 Hearings").

⁶⁵ S. 470 Report at 11-14.

⁶⁶ Hearings on S. 249 ("Securities Acts Amendments of 1975") Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess. 21 (1975).

STATEMENT OF EDGAR F. BUNCE, JR., CHAIRMAN, COMMITTEE ON
SECURITIES INVESTMENTS, AMERICAN COUNCIL OF LIFE INSUR-
ANCE, ACCOMPANIED BY PAUL J. MASON, CHIEF COUNSEL

Mr. BUNCE. Mister Chairman and members of the subcommittee, I am Edgar F. Bunce, Jr., senior vice president in charge of the Common Stock Department of the Prudential Insurance Co. of America, and I am appearing on behalf of the American Council of Life Insurance, of which I am the chairman of the Securities Investment Committee, and I am accompanied by Paul J. Mason, chief counsel, securities, of the American Council of Life Insurance. The council has a membership of 472 life insurance companies who represent 96 percent of the total assets of all U.S. life insurance companies and U.S. branches of Canadian companies. We appreciate the opportunity you have extended to us to comment on H.R. 11140.

Incidentally, I may skip some of the quotations in the text, but I would like to have my full statement filed for the record.

Mr. ECKHARDT. Without objection, it will be so ordered.

Mr. BUNCE. The council would like to express the opposition of its members to any postponement of the effective dates in section 11(a)(1) of the Securities Exchange Act of 1934. We took an active role in the development of that section prior to its enactment as part of the Securities Acts Amendments of 1975. In June and July of 1977, as you are aware, the Subcommittee on Consumer Protection and Finance held joint oversight hearings with the Subcommittee on Oversight and Investigations to examine the functioning and administration of the Securities Acts Amendments of 1975. We had the opportunity to appear before the subcommittee on July 19, 1977, and in connection with the consideration being given to section 11(a) we commented extensively with respect to the Commission's proposed rules then under consideration.

During those hearings section 11(a) received substantial attention and the subcommittee stated the following conclusions in its report:

We would not at this time reopen the basic question of the separation of brokerage and money management.

It also said:

Much of the economic incentive for institutional money managers to move into the brokerage business was removed, while at the same time brokerage firms which manage accounts were precluded from doing the brokerage for those managed accounts."

And yet, H.R. 11140 does reopen many of the fundamental questions that the Congress last summer concluded not to raise. It is true that H.R. 11140 calls only for a delay, but it is apparent from the Commission's own statement in support of this proposed legislation that much more may be intended. It is not a delay which is the paramount concern of the Commission, but rather a reopening of the issues which the Congress only 6 months ago concluded it did not want reopened. Statements such as the following from the Commission's letter and memorandum are not in the context of a delay but rather a permanent abolition of the Section: For example, "Section 11(a) is no longer needed to redress a competitive imbalance."

"... Full implementation of that section would appear to put exchange members ... at a severe disadvantage."

The Commission's letter and memo offer assertions and warnings which, we believe, are not sufficiently developed or documented to serve as the basis for amending this important section of this statute. We have several general concerns with respect to the Commission's approach. First, we feel that the Commission's eleventh-hour legislative proposal and its accompanying brief review of the issues are not a suitable culmination of the exhaustive proceedings on these issues that have gone before. In addition, we are concerned over the Commission's casual dismissal of the institutional membership question. While currently not a major problem, we are unwilling to conclude that the issue has disappeared. Pressures for institutional membership may well reoccur at some time in the future depending on, among other things, fluctuations in prevailing commission rate levels and in the profitability of order handling. Finally, we note that the Commission makes no mention of the conflict of interest question which has heretofore been so exhaustively discussed.

We have several additional concerns with respect to the Commission's position. First, the Commission makes the argument that steps which may be taken in connection with implementation of the national market system may in some undefined fashion relate to section 11(a). Certainly, a careful reading of the SEC's recently released Policy Statement on the National Market System, in which the Commission sets forth its views as to those initiatives which it believes must be taken over the next year to facilitate the establishment of a national market system, does not shed any light on this interrelationship. In all of its discussion of composite quotation systems, market linkage and order routing systems, limit order protection and consolidated transaction reporting systems, no argument is made or explanation provided which ties in to section 11(a).

Second, while many of us may share the Commission's implicit concern for the well-being of small regional brokerage firms, we find it difficult to accept the argument that such firms will be "substantially disadvantaged in competing as money managers." That argument is based principally on the assertion that regional brokers cannot compete unless they can charge brokerage to the accounts they manage. Without additional documentation, we find this assertion unconvincing, particularly since regional money managers whose fee is not part of the brokerage dollar, do exist.

Third, the Commission's argument that enforcement problems warrant a delay is totally inconsistent with its record of activity in this area. To this Commission argument we cite the following statement in the November 15, 1977, joint subcommittee report:

Clearly, there is a risk that broker-dealers with managed accounts will devise reciprocal practices in an effort to circumvent Section 11(a). This problem was recognized as early as 1972 in the report of the then Subcommittee on Commerce and Finance. Now, as then, the subcommittees intend to rely on regulation and vigorous enforcement action by the Securities and Exchange Commission to prevent such reciprocal practices.

It should be noted, however, that many of the reciprocal practices the SEC fears will develop are clearly prohibited by section 11(a). The SEC has substantial experience in detecting and exposing un-

lawful reciprocity. There is no basis for Congress to believe that the SEC will not be equal to its present task.

We perceived an emerging consensus developing with respect to the desirability and workability of section 11(a)(1) following the publication of the subcommittee's report in November 1977. Accordingly, we believe that at this point in time the burden of proof lies with the SEC or others who would derail 11(a), and we do not believe that anyone has met that test. Congress, when it passed section 11(a), was cognizant of the changes confronting the securities markets and took those changes into account, and in reviewing this matter last summer it concluded to leave the section intact.

We, therefore, respectfully submit that no case has been made to support a postponement of section 11(a).

Thank you.

[Mr. Bunce's prepared statement follows:]

STATEMENT OF EDGAR F. BUNCE, JR., CHAIRMAN, COMMITTEE ON SECURITIES
INVESTMENTS, AMERICAN COUNCIL OF LIFE INSURANCE

Mister Chairman and members of the Subcommittee, I am Edgar F. Bunce, Jr., Senior Vice President in charge of the Common Stock Department of Prudential Insurance Company of America and I am appearing on behalf of the American Council of Life Insurance. I am accompanied by Paul J. Mason, Chief Counsel, Securities, of the American Council of Life Insurance. The Council has a membership of 472 life insurance companies who represent 96 percent of the total assets of all United States life insurance companies and U.S. life insurance companies and U.S. branches of Canadian companies. We appreciate the opportunity you have extended to us to comment on H.R. 11140.

The Council would like to express the opposition of its members to any postponement of the effective dates in Section 11(a)(1) of the Securities Exchange Act of 1934. We took an active role in the development of that Section prior to its enactment as part of the Securities Acts Amendments of 1975. In June and July of 1977, as you are aware, the Subcommittee on Consumer Protection and Finance held joint oversight hearings with the Subcommittee on Oversight and Investigations to examine the functioning and administration of the Securities Acts Amendments of 1975. We had the opportunity to appear before the Subcommittee on July 19, 1977 and in connection with the consideration being given to Section 11(a) we commented extensively with respect to the Commission's proposed rules then under consideration.

During those hearings Section 11(a) received substantial attention and the Subcommittee stated the following conclusions in its report:

(1) "We would not at this time reopen the basic question of the separation of brokerage and money management. With respect to the proper interpretation of the existing provision, the Congress intended that exchange members with managed accounts should be permitted to arrange to have other exchange members execute transactions for those accounts. The exchange member managing the account should not, however, receive any compensation for making such brokerage arrangements."¹

(2) "That section (Section 11(a)) was the result of a compromise reached after considerable debate. As a result of the section, much of the economic incentive for institutional money managers to move into the brokerage business was removed, while at the same time brokerage firms which manage accounts were precluded from doing the brokerage for those managed accounts.

"It was argued at the hearings that the section, which takes full effect on May 1, 1978, should be amended, repealed or further delayed. The argument is that the section will cause great disruption to the securities industry. That is a somewhat anomalous concern at this point, since the securities industry

¹ Report by the Subcommittee on Oversight and Investigations and the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce on "Oversight of the Functioning and Administration of the Securities Acts Amendments of 1975," dated Nov. 15, 1977, p. 3.

itself was largely responsible for the inclusion of the section in the 1975 Amendments. Having struggled greatly with the issue of brokerage for managed accounts in enacting the legislation, and in light of the fact that the SEC was given broad rulemaking authority to adjust or extend to other markets the impact of the section, the subcommittees are not inclined to reopen the fundamental question."²

And yet, H.R. 11140 does reopen many of the fundamental questions that the Congress last summer concluded not to raise. It is true that H.R. 11140 calls only for a delay, but it is apparent from the Commission's own statement in support of this proposed legislation that much more may be intended. It is not a delay which is the paramount concern of the Commission, but rather a reopening of the issues which the Congress only six months ago concluded it did not want reopened. Statements such as the following from the Commission's letter and memorandum are not in the context of a delay but rather a permanent abolition of the Section:

"Section 11(a) is no longer needed to redress a competitive imbalance."

"... Full implementation of that section would appear to put exchange members ... at a severe disadvantage."

The Commission's letter and memo offer assertions and warnings which, we believe, are not sufficiently developed or documented to serve as the basis for amending this important section of this statute. We have several general concerns with respect to the Commission's approach. First, we feel that the Commission's eleventh-hour legislative proposal and its accompanying brief review of the issues are not a suitable culmination of the exhaustive proceedings on these issues that have gone before. In addition, we are concerned over the Commission's casual dismissal of the institutional membership question. While currently not a major problem, we are unwilling to conclude that the issue has disappeared. Pressures for institutional membership may well re-occur at some time in the future depending on, among other things, fluctuations in prevailing commission rate levels and in the profitability of order handling. Finally, we note that the Commission makes no mention of the conflict of interest question which has heretofore been so exhaustively discussed.

We have several additional concerns with respect to the Commission's position. First, the Commission makes the argument that steps which may be taken in connection with implementation of the national market system may in some undefined fashion relate to Section 11(a). Certainly a careful reading of the SEC's recently released Policy Statement on the National Market System, in which the Commission sets forth its views as to those initiatives which it believes must be taken over the next year to facilitate the establishment of a national market system, does not shed any light on this interrelationship. In all of its discussion of composite quotation systems, market linkage and order routing systems, limit order protection and consolidated transaction reporting systems, no argument is made or explanation provided which ties in to Section 11(a).

Secondly, while many of us may share the Commission's implicit concern for the well-being of small regional brokerage firms, we find it difficult to accept the argument that such firms will be substantially disadvantaged in competing as money managers." That argument is based principally on the assertion that regional brokers cannot compete unless they can charge brokerage to the accounts they manage. Without additional documentation, we find this assertion unconvincing, particularly since regional money managers whose fee is not part of the brokerage dollar do exist.

Thirdly, the Commission's argument that enforcement problems warrant a delay is totally inconsistent with its record of activity in this area. To this Commission argument we cite the following statement in the November 15, 1977 joint Subcommittee report:

"Clearly, there is a risk that broker-dealers with managed accounts will devise reciprocal practices in an effort to circumvent Section 11(a). This problem was recognized as early as 1972 in the report of the then Subcommittee on Commerce and Finance. Now, as then, the subcommittees intend to rely on regulation and vigorous enforcement action by the Securities and Exchange Commission to prevent such reciprocal practices."

It should be noted, however, that many of the reciprocal practices the SEC fears will develop are clearly prohibited by Section 11(a). The SEC has sub-

² *Id.*, p. 9.

stantial experience in detecting and exposing unlawful reciprocity. There is no basis for Congress to believe that the SEC will not be equal to its present task.

We perceived an emerging consensus developing with respect to the desirability and workability of Section 11(a)(1) following the publication of the Subcommittee's Report in November, 1977. Accordingly, we believe that at this point in time the burden of proof lies with the SEC or others who would derail 11(a), and we do not believe that anyone has met that test. Congress, when it passed Section 11(a), was cognizant of the changes confronting the securities markets and took those changes into account, and in reviewing this matter last summer it concluded to leave the Section intact.

We, therefore, respectfully submit that no case has been made to support a postponement of Section 11(a).

Mr. ECKHARDT. Mr. Silver.

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. SILVER. Thank you, Mr. Chairman. My name is David Silver. I am president of the Investment Company Institute which is the national association of the mutual fund industry. Our 446 member mutual funds have approximately 7 million shareholders and \$45 billion in assets. The Institute represents over 90 percent of the industry.

Mr. Chairman, in your opening statement yesterday, you remarked that there was little logic to any of this, and if you haven't been convinced of this by the witnesses thus far, perhaps I will be able to do so.

The issue which you are considering today is whether to accept the proposal of the SEC to postpone the effective date of section 11(a)(1) of the Securities Exchange Act from May 1, 1978 to November 1, 1979. Other witnesses have spoken from the perspective of those who either want institutional affiliated exchange membership or those who oppose it. Although these witnesses are at polar extremes on the issue, their perspective is the same in that their common focus is exchange membership. I would like to change the focus to the institutional investor as such and bring to your view an important problem which is generic to this segment of the investment community.

Section 11(a), which was added to the Securities Exchange Act as part of the Securities Acts Amendments of 1975, would prohibit stock exchange member firms from executing orders for institutional accounts they manage. The section would also prohibit institutional investors, such as banks, insurance companies, pension funds and mutual fund organizations from joining national securities exchanges.

Regardless of the merits of the mandatory separation of brokerage and money management functions, any significant postponement of the effective date of section 11(a) will have the effect of exerting pressure on institutions and those who manage institutional accounts to engage in brokerage activities contrary to the legislative purpose underlying the enactment of the section. The reason for this lies in the continuing fear of many institutional investors that they will be subjected to protracted and expensive litigation asserting that there is some legal duty on investment managers to engage in brokerage

activities in order to minimize brokerage costs of affiliated institutional accounts.

I am not trying to assert that the concerns of some institutional investors do not go beyond the desire to avoid litigation. These institutions are worried about competitive issues which arise from affiliations between stock brokers and institutional accounts managed by such brokers.

Most institutional investors, whatever their views on the policy issue underlying section 11(a), do hold one major concern in common—they are greatly disturbed about the continued uncertainty as to whether, contrary to their best business judgment, affiliates of institutional accounts can be compelled to join stock exchanges in order to minimize brokerage costs. This uncertainty has persisted despite a 1969 opinion of the General Counsel of the SEC that there is no such duty. Whatever its other virtues, section 11(a) would have ended this prolonged period of doubt, confusion and the never-ending litigation. However, under the present SEC proposal, there is to be a delay and inevitably the future is once more uncertain. As a result, investment advisers may become the unintended victims of a shift in policy on the issue of institutional membership.

In the 15 year meandering history of institutional membership on stock exchanges, the SEC, subjected to conflicting policy considerations, did not find it possible to formulate or enunciate a consistent policy which would have enabled institutions to determine what they should do with respect to exchange membership. Those who have followed this matter closely might identify at least three phases in the evolution of SEC policy. From about 1963 until 1971, the SEC seemed to favor institutional membership even though it permitted the major exchanges to maintain restrictive admission policies. For about a year the Commission then reassessed its position. Finally, in February 1972, the SEC, seemingly reversing its earlier positions, took a fairly clear stance against unrestricted institutional exchange membership in its statement on the future structure of the securities markets. It seems that with these hearings we may be entering a fourth phase in which the SEC once again reassesses its position in light of the new circumstances contained in its statement. In view of the history of this issue and the litigation which it aroused, it should not be surprising that most institutional investors greeted the enactment of section 11(a) with relief and believed it laid the matter to rest. But now, the question is to be reopened for reasons having nothing to do with the issue that concerns most institutional managers.

We believe that at least the problem on which I have focused which would be caused by reopening the issue of institutional membership can be substantially ameliorated, if not eliminated, by amending section 11(a) to make it plain that institutional investors and managers and institutions do not have to join exchanges or enter into the brokerage business. Such a provision would simply confirm that institutional managers have a option not to join exchanges and would be wholly consistent with, and indeed tend to implement, the policy of section 11(a) and parallel requirements of ERISA. We think such a provision for the reasons stated would be

a rational concomitant to the SEC proposal should you decide to accept it. I do recognize that the necessity for such a provision would depend on what you do with the existing grandfather clause. I should state also that even if you determine not to go forward with the SEC proposal and section 11(a)(1) becomes effective, we may well be back in the future to request legislative action since the problem for institutional investors involves underwritings as well as transactions taking place on stock exchanges.

We think that our proposal would command wide support throughout the securities industry and among most institutional investors, and even some of those on either side of the substantive issue. We would also note that the SEC in support of its proposal observed that the pressures for institutional membership had alleviated under the regime of negotiated commission rates. This may be so, but the issue will not be laid to rest until it is generally understood that the law is neutral and that the goal of uncertainty is removed from the question of whether institutional investors should engage in brokerage activities—a matter which should be left to business judgment.

Now, I have attached to my statement, Mr. Chairman, a proposed amendment to section 11(a)(1) which would implement the thrust of what I talked about, and I would ask that the entire statement be included in the record.

Mr. ECKHARDT. Without objection it will be so ordered.

[Mr. Silver's prepared statement follows:]

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE

My name is David Silver. I am President of the Investment Company Institute which is the national association of the mutual fund industry. Our 446 member mutual funds have approximately 7 million shareholders and \$45 billion in assets. The Institute represents over 90 percent of the industry.

The issue which you are considering today is whether to accept the proposal of the SEC to postpone the effective date of Section 11(a)(1) of the Securities Exchange Act from May 1, 1978 to November 1, 1979. Other witnesses have dealt with the issue from the perspective of those who either want institutional affiliated exchange membership or those who oppose it. Although these witnesses are at polar extremes on the issue, their perspective is the same in that their common focus is exchange membership. I would like to change the focus to the institutional investor as such and bring to your view an important problem which is generic to this segment of the investment community.

Section 11(a), which was added to the Securities Exchange Act as part of the Securities Acts Amendments of 1975, would prohibit stock exchange member firms from executing orders for institutional accounts they manage. The Section would also prohibit institutional investors such as banks, insurance companies, pension funds and mutual fund organizations from joining national securities exchanges. Whether the legislative decision on institutional membership in 1975 was right or wrong is not at issue in this hearing. For present purposes it suffices to say that the bar on exchange membership represents a policy determination that the issues surrounding such membership should be resolved by prohibiting the dual function of investment management and brokerage with respect to the same account. The Employee Retirement Income Security Act of 1974 (ERISA) contains similar prohibitions reflecting the same policy determination.

Regardless of the merits of the mandatory separation of brokerage and money management functions, any significant postponement of the effective date of Section 11(a) will have the effect of exerting pressure on institutions and those who manage institutional accounts to engage in brokerage activities contrary to the legislative purpose underlying the enactment of the

Section. The reason for this lies in the continuing fear of many institutional investors that they will be subjected to protracted and expensive litigation asserting that there is some legal duty on investment managers to engage in brokerage activities in order to minimize brokerage costs of affiliated institutional accounts. It is this fear which spurred many institutional investors to support the enactment of Section 11(a) as the only way of avoiding endless litigation on this subject.

I am not trying to assert that the concerns of some institutional investors do not go beyond the desire to avoid litigation. These institutions are worried about competitive issues which arise from affiliations between stock brokers and institutional accounts managed by such brokers. Since these investment managers eschew such relationships as a matter of principle, they are understandably concerned that those who do not share this view may gain an unfair competitive advantage should such affiliations be permitted to continue. Other institutional investors either do not share the underlying concern or, if they do, are not troubled by the competitive problem.

Most institutional investors, whatever their views on the policy issue underlying Section 11(a), do hold one major concern in common—they are greatly disturbed about the continued uncertainty as to whether, contrary to their best business judgment, affiliates of institutional accounts can be compelled to join stock exchanges in order to minimize brokerage costs. This uncertainty has persisted despite a 1969 opinion of the General Counsel of the SEC that there is no such duty (Sec. Ex. Act Rel. No. 8746). Whatever its other virtues, Section 11(a) would have ended this prolonged period of doubt, confusion and the never-ending litigation. However, under the present SEC proposal, there is to be a delay and inevitably the future is once more uncertain. As a result, investment advisers may become the unintended victims of a shift in policy on the issue of institutional membership.

In the fifteen year meandering history of institutional membership on stock exchanges, the SEC, subjected to conflicting policy considerations, did not find it possible to formulate or enunciate a consistent policy which would have enabled institutions to determine what they should do with respect to exchange membership. Those who have followed this matter closely might identify at least three phases in the evolution of SEC policy. From about 1963 until 1971 the SEC seemed to favor institutional membership even though it permitted the major exchanges to maintain restrictive admission policies. For about a year the Commission reassessed its position. Finally, in February 1972 the SEC, seemingly reversing its earlier positions, took a fairly clear stance against unrestricted institutional exchange membership in its "Statement on the Future Structure of the Securities Markets."¹ It seems that with these hearings we may be entering a fourth phase in which the SEC once again reassesses its position in light of the new circumstances contained in its statement. In view of the history of this issue and the litigation which it aroused, it should not be surprising that most institutional investors greeted the enactment of Section 11(a) with relief and believed it laid the matter to rest. But now the question is to be reopened for reasons having nothing to do with the issue that concerns most institutional managers.

We believe that at least this problem caused by reopening the issue of institutional membership can be substantially ameliorated, if not eliminated, by amending Section 11(a) to make it plain that institutional managers and institutions do not have to join exchanges or enter into the brokerage business. Such a provision would simply confirm that institutional managers have a option not to join exchanges and would be wholly consistent with, and indeed tend to implement, the policy of Section 11(a) and ERISA. We think such a provision for the reasons stated would be a rational concomitant to the SEC proposal should you decide to accept it. I should state that even if you determine not to go forward with the SEC proposal and Section 11(a) (1) becomes effective, we may well be back in the future to request legislative action since the problem for institutional investors goes beyond transactions taking place on stock exchanges.

We think that our proposal would command wide support throughout the the securities industry and among most institutional investors. We would also note that the SEC in support of its proposal observed that the pressures for

¹ See also "Statement of the Chairman of the SEC to the Senate Subcommittee on Securities, April 20, 1972" p. 29.

institutional membership had alleviated under the regime of negotiated commission rates. This may be so, but the issue will not be laid to rest until it is generally understood that the law is neutral and that the goad of uncertainty is removed from the question of whether institutional investors should engage in brokerage activities—a matter which should be left to business judgment.

PROPOSED AMENDMENT TO SECTION 11(a) (1)

No investment adviser or any affiliated person of such an adviser shall have any duty to become a member of a national securities exchange or to engage in securities transactions as a broker or dealer on behalf of any account with respect to which such adviser or affiliated person exercises investment discretion except as may be agreed between the parties to an advisory agreement.

Mr. ECKHARDT. Mr. Vinyard.

Mr. VINYARD. Thank you, Mr. Chairman. Without objection, I would like to simply file my statement for the record, and skip thought parts of it. I would be glad to answer questions on any aspect of it.

Mr. ECKHARDT. Without objection, that will be permitted.

**STATEMENT OF WALTER D. VINYARD, JR., SENIOR COUNSEL,
AMERICAN INSURANCE ASSOCIATION**

Mr. VINYARD. My name is Walter Vinyard, and I am senior counsel for the American Insurance Association, which is a national trade association for property-casualty insurers. At the end of 1977, our industry held over \$100 billion in invested assets of which approximately \$18 billion is estimated to be in common stock. Equity investments over the past 40 years have helped finance the costs of meeting accelerating demands for insurance coverage throughout the American economy.

For over 5 years, our association supported efforts by this subcommittee under the chairmanship of Congressman John Moss to enact the 1975 Securities Act Amendments. President Carter spoke at the White House February 22, 1978 of his deep admiration for Chairman Moss' service in the House of Representatives. One of the ways in which Mr. Moss earned our members' admiration was the objectivity with which he received all points of views as the 1975 amendments evolved. The reforms mandated in 1975 will create stronger and fairer equity markets, provided the law is administered in the same spirit it was enacted. Better equity markets should promote capital investment in all economic sectors by individuals and institutions, both foreign and domestic.

We are opposed to the 18-month extension which the SEC seeks in H.R. 11140. The way in which the Commission has discharged its responsibilities in meeting the mandate and the May 1978 deadline Congress enacted in 1975 raises serious questions of public policy. The Commission's failure to promulgate rules which reflect the legislative intent of the 1975 amendments, and the way in which it has administered the rulemaking process require Congress to exercise its oversight function with more vigilance.

One of the most important provisions in the 1975 Amendments altered section 11(a) in the 1934 act. Congress declared:

"It shall be unlawful for any member of a national securities exchange to effect any transaction on such exchange for its own account, the account of

an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion.

This policy was written to settle one of the most controversial issues in the investment community. It was drafted after two comprehensive studies by the House and Senate.

Congressional action was necessary on the question of exchange members trading for managed institutional accounts because of disruptive SEC rulemaking.

I have several pages in our statement of legislative history underlying section 11(a), which I would like to skip. I would like to point out those excerpts come from statements made on the floor of the House or in committee about the intent of the bill, rather than remarks that might have been made outside of congressional deliberations on what might have been in the legislation.

The intent of Congress in amending section 11(a) (1) seemed clear to us. As the study of this subcommittee under Chairman Moss emphasized:

The subcommittee finds that there is no necessity to require that broker-dealers choose between the brokerage or the money management business. We find, however, that the conflicts are significant enough to warrant amending the Securities Exchange Act to prohibit registered broker-dealers from directly or indirectly performing brokerage transactions for their affiliated accounts. . . . Thus broker-dealers could choose to manage certain accounts with the knowledge that they could not engage in brokerage transactions for those accounts, while electing not to manage other accounts in the hope that they could obtain brokerage business from them.

That is a report was issued by this subcommittee on the 1975 amendments.

In January 1976 the SEC began to question, among other things, the interpretation of "effect" in amended section 11(a) (1). There were several proposals which went back and forth, some of which seemed diametrically opposed to others. The only common characteristic, in our opinion, was that few of them seemed related to the purpose or intent of the 1975 amendments. Most of the second series of SEC interpretations in 1977 would have nullified any statutory prohibitions against trading for managed institutional accounts.

This subcommittee, together with Chairman Moss' Subcommittee on Oversight and Investigations, has shown the SEC how to promulgate responsible rules implementing section 11(a) (1). Your recent Oversight report stated: Merely arranging for brokerage (as distinguished from actually executing the transaction) is an integral part of the function of managing an account; therefore, to prohibit a member from arranging to have another member perform brokerage for the first member's managed accounts would create such a serious obstacle that the first member would be forced to abandon managing that account, or to withdraw exchange membership.

Your report recognizes "a primary purpose of section 11(a) was to place broker-dealers with managed accounts on the same footing as their competitors, such as bank trust departments. . . ." Bank trust departments trade for managed accounts through unaffiliated broker-dealers. Your report also recognizes "it is permissible under section 11(a) for an exchange member to arrange for another member to execute transactions which the first member orders on behalf

of an account under its management." The report cautions that brokers must not retain any compensation for making such arrangements. Against this background of thorough and objective study by the House and Senate before passing the 1975 amendments, and the excellent Oversight Report in 1977, it is difficult to understand why the SEC has not promulgated final regulations. The Commission has had 3 years to define the word "effect." Surely this is not quite as strenuous or controversial as the SEC suggests. Surely the public has a right to know what to expect May 1, 1978.

The SEC's latest tactic is to characterize one of its other directives in the 1975 amendments as inconsistent with section 11(a). Section 20A of the 1934 act, which you amended in 1975, directs the SEC to take such steps as are within its power to establish a national market system for transactions in securities. Section 20A states that such a system shall include, as a minimum: A transactional reporting system, a composite quotation system and a system of rules and regulations designed to provide fair competition. On January 26, 1978, the Commission published a release on the national market system. The release acknowledges the necessity of an intermarket routing system, and a universally available message switch. No specific date for implementation is given. The Commission does say it "is not aware of any reason why both of these facilities should not be implemented by September 30, 1978." In his February 22, 1978 letter to the Speaker of the House and the President of the Senate, the SEC Chairman rationalizes delaying the May first deadline as follows: Full implementation of the trading prohibitions of section 11(a) . . . would be undesirable in light of the continuing rapid pace of economic, technological, and regulatory changes in the markets. . . . This . . . will necessarily be accelerated during the next several months by steps which must be taken to implement the national market system.

Congress was fully aware of the relationship between development of a national market system, and the prohibition on brokers trading for managed institutional accounts. Rather than being inconsistent with a national market system, a prohibition upon exchange members trading for managed institutional accounts was seen by Congress as essential before further progress could occur. The mandate Congress gave the SEC in 1975 was to "remove impediments of a national market system for securities." One of the chief impediments is that money managers have been encouraged to trade for managed accounts. Congress decided to resolve this question in 11(a), and to do so in an evenhanded way which would allow all to compete for the right to manage other people's money on a fair basis. Congress felt so strongly about this that a statutory deadline of May 1, 1978, was written into the law. The SEC was given rule-making power to implement the prohibition. Eight exceptions were enumerated.

In other provisions of the 1975 amendments, Congress inserted failsafe powers, or granted the SEC discretion to delay deadlines provided it could establish certain findings of fact. I might say we supported 11(a) as it finally was written into law, as it evolved through this subcommittee, the full committee, and the floor of the

House. We did not object to a number of amendments that the securities industry asked for. Many in our membership thought we might have been too accommodating. I still think section 11(a) is meaningful, and will be a positive contribution to the market. I am somewhat skeptical, even if we started over again today, that we would wind up much differently than we did with legislation in 1975.

The way the SEC has administered its responsibilities under section 11(a), and its request for an 18 month extension in the May 1st deadline will become a heavy burden for the Commission to carry if it intends to perfect the mechanism for a national market system. I am skeptical the New York Stock Exchange will appear on the Commission's doorstep September 30, 1978 to hand over its market linkage and order routing systems for use in the over-the-counter market. Having caused confusion and controversy over section 11(a) during the past 3 years, what will the SEC do when it faces hard decisions on the market linkage and order routing systems? Having asked Congress to extend the statutory deadline in section 11(a), how can the Commission expect anyone to regard its own September 30 deadline seriously? If the Chairman of the SEC believes an 18 month delay is needed because "several of the commentators on . . . section 11(a), including the Securities Industry Association, have changed their positions . . . one or more times," what will he propose when he faces an issue of major economic importance to the securities industry, rather than one which interests a relatively small number of brokerage firms? Despite several statements in the transmission to House Speaker O'Neill that full implementation of section 11(a) will "engender anticompetitive effects that were not, and could not have been, anticipated 3 years ago," the Commission fails to include one piece of empirical economic evidence to support its claims. I might say, Mr. Chairman, a year or two ago the Commission came to Congress and asked for a larger budget authorization precisely to hire professional economists that could provide this kind of information. It is surprising to see it totally lacking from this submission to Congress.

If the consequences of implementing section 11(a) are so grave, it does seem the Commission's economists would have analyzed this problem at some point during the past 3 years. I have seen nothing in the Commission's submission which was not studied with unusual care during evolution of the 1975 amendments. Chairman John Moss commented at one point in hearings on the 1975 amendments that "most industries study problems to death, but the securities industry likes to study solutions to death." The Commission appears now to be taking this approach.

The heart of the SEC's current argument is full implementation of section 11(a) will "put exchange members" and particularly regional and small members, at a severe disadvantage" and will "exacerbate the existing trend towards concentration in the securities industry."

This scenario is difficult to accept. Our members appreciate the importance of a strong regional broker-dealer network, and recognize their essential position in raising capital. When smaller, regional

broker-dealers manage other people's money they are not competing with the Prudential Insurance Co. or Morgan Guaranty Trust. Smaller institutional accounts in regional cities usually place a premium upon convenience, geographic location, and prior personal relationships in addition to considering costs and performance. I can't understand why the broker-dealer in Morganton, N.C. or Tyler, Tex. would lose all of its managed accounts to Chicago banks or Boston insurance companies in section 11(a) were implemented. If the SEC thinks predatory pricing in the Securities Industry has occurred, or does occur, then the Chairman should turn over evidence to the U.S. Department of Justice for immediate investigation and possible prosecution. Predatory pricing is a serious allegation. It is not something to be tolerated, nor something to be insinuated without actual evidence.

We also believe the beneficiaries of accounts managed by regional brokers would profit by having management charges disclosed, rather than paying for management services through brokerage commissions. Under competitive rates, brokers who manage other people's money have to determine, without the benefit of arm's length bargaining, what constitutes a fair commission charge for transactions executed for managed accounts. It strikes me as odd that the SEC approves of a system under which beneficiaries receive no disclosure of management fees.

Under competitive rates, churning may become a more serious problem for beneficiaries of managed accounts. As profits diminish on each brokerage transaction, brokers may seek to increase volume in order to maintain profits. Nowhere would this be more tempting than a managed institutional account over which a broker-dealer has discretionary authority. "Parking" or "dumping" is enticing in management of institutional accounts. Broker-dealers often acquire large blocks of securities in underwritings, block positioning or arbitrage. Occasionally these securities are not sold with the degree of ease anticipated. Institutional accounts are tempting places to dispose of excess securities. Moreover, a broker-dealer could also earn a substantial commission in making such a placement.

Section 11(a)(1) merely requires that brokers not profit from orders generated by managed accounts. By requiring captive orders from managed accounts to be effected by independent broker-dealers, section 11(a) might enhance rather than diminish, competition in the securities industry. Economics of scale in the brokerage business are not strong. It would have been interesting to have the SEC's point of view on that question. We see no reason why well-managed broker-dealers in regional cities throughout the United States will not continue to prosper after May 1, 1978.

If a brokerage firm would be jeopardized by promulgation of reasonable SEC rules implementing section 11(a) on May 1, 1978, then the level of its commission rates, and the quality of its service to managed institutional accounts are open to serious question. In one statement, the SEC suggests commission rates are so low there is no longer a profit incentive to join exchanges. In the next statement, the SEC says so many brokers depend upon commission income from managed institutional accounts that our nationwide network

of regional firms will be destroyed when section 11(a) is implemented May 1, 1978. I find it difficult to reconcile those two statements.

Perhaps the most incredible section of the Commission's transmission to the Speaker is a series of arguments that section 11(a) should not be enforced because it might "lead to a variety of direct and indirect reciprocal practices by which . . . exchange members . . . could recapture the economic benefit of brokerage revenues paid to unaffiliated members." The SEC states "member firms deal with each other in so many different ways that it may be impossible in many cases to enforce any prohibition on reciprocity." It suggests "a substantial portion of the Commission's resources will have to be devoted to enforcement action under section 11(a)," and its "enforcement efforts may be severely hampered by parties who choose to litigate."

Is this the same agency which told the House Agriculture Committee recently that it could do a better enforcement job than the Commodity Futures Trading Commission, and should be given jurisdiction over a substantial portion of futures trading? Is this the same agency which captures headlines with its investigations of Bert Lance, Tongsun Park, and the President's own nominee to head the Federal Reserve System? Is this the same agency which used the Federal securities laws to highlight the problem of foreign payments? Is it the agency with which the largest corporations in the United States, if not in the free world, sign consent decrees rather than face litigation? Wasn't the SEC the agency which stopped "give ups" in the sale of mutual funds? The SEC's reasoning is so unconvincing one wonders why it is advanced. Perhaps the intent is to promote a larger budget authorization for the Enforcement Division.

In 1975 Congress directed the SEC to stop broker-dealers from trading for managed institutional accounts on May 1, 1978. Since President Ford signed the bill into law, the SEC has generated controversy and confusion over the appropriate way to implement the statute. The SEC's administration of section 11(a) raises serious questions about its willingness to implement national policy written by Congress. We oppose the SEC's request for an eighteen month delay. We respectfully request the Congress to admonish the SEC to implement and enforce the law on May 1, 1978, in the reasonable way suggested by the House oversight report in 1977. The Commission has more than sufficient authority to deal with any unanticipated problems which may arise after May 1, 1978.

Thank you.

[Mr. Vinyard's prepared statement follows:]

STATEMENT OF WALTER D. VINYARD, JR., SENIOR COUNSEL, AMERICAN INSURANCE ASSOCIATION

The American Insurance Association is a national trade association for property-casualty insurers. At the end of 1977, our industry held over \$100 billion in invested assets, of which approximately \$18 billion is estimated to be in common stock. Equity investments over the past forty years have helped finance the costs of meeting accelerating demands for insurance coverage throughout the American economy.

We appreciate the opportunity to comment on H.R. 11140, introduced February 23, 1978 by the knowledgeable Chairman of this Subcommittee, Mr.

Eckhardt, and its distinguished ranking minority member, Mr. Broyhill, at the request of the Securities and Exchange Commission [SEC or the Commission]. Although the introduction of this measure comes as something of a surprise, and the early hearing date has not afforded us much opportunity for preparation, this is a subject of great importance to our members. For over five years, our Association supported efforts by this Subcommittee under the chairmanship of Congressman John Moss to enact the 1975 Securities Acts Amendments. President Carter spoke at the White House February 22, 1978 of his deep admiration for Chairman Moss' service in the House of Representatives. One of the ways in which Mr. Moss earned our members' admiration was the objectivity with which he received all points of view as the 1975 Amendments evolved. The reforms mandated in 1975 will create stronger and fairer equity markets, provided the law is administered in the same spirit it was enacted. Better equity markets should promote capital investment in all economic sectors by individuals and institutions, both foreign and domestic.

We are opposed to the eighteen month extension which the SEC seeks in H.R. 11140. The way in which the Commission has discharged its responsibilities in meeting the mandate and the May 1978 deadline Congress enacted in 1975 raises serious questions of public policy. The Commission's failure to promulgate rules which reflect the legislative intent of the 1975 Amendments, and the way in which it has administered the rulemaking process require Congress to exercise its oversight function with more vigilance.

One of the most important provisions in the 1975 Amendments altered Section 11(a) in the 1934 Act. Congress declared "it shall be unlawful for any member of a national securities exchange to effect any transaction on such exchange for its own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion." This policy was written to settle one of the most controversial issues in the investment community. It was drafted after two comprehensive studies by the House and Senate.

Congressional action was necessary on the question of exchange members trading for managed institutional accounts because of disruptive SEC rulemaking. The Senate Committee on Banking, Housing and Urban Affairs found: "Rule 19b-2 represents a regretful chapter in the Commission's generally distinguished history. The bill is designed to eliminate all traces of this inappropriate regulatory interference with legitimate competitive forces."¹ The Commission's enthusiasm was not noticeable towards legislative attempts to resolve the issue of trading for managed institutional accounts. When legislation was pending before the Senate Banking Committee during the first half of 1973, the SEC urged Congress to allow the entire question to be settled through Commission rulemaking.² The Senate Committee rejected this approach. When S.470 passed the Senate in June 1973, with only two or three negative votes, section 11(a) was substantially similar to the way in which it was signed into law June 4, 1975. In response to other requests, the SEC was given:

"Authority to regulate all trading by members and their affiliated persons from on or off the floor of an exchange. . . . The SEC is also given the power to exempt transactions by affiliated persons of exchange members who are natural persons, e.g., officers, directors and employees. . . . [M]any employees and individual stockholders of member firms do not, by virtue of that affiliation alone, have trading advantages over public investors. . . . Pursuant to its expanded power, the Commission does not have the authority to adopt or enforce rules inconsistent with the policies established by the bill concerning members trading with affiliated persons or the separation of the functions of brokerage and institutional money management. . . ."

The House counterpart, H.R. 5050, was not reported from the Committee on Interstate and Foreign Commerce until November 19, 1974, late in the second session of the 93rd Congress. The reported bill contained two significant differences from S. 470 in its approach towards amending section 11(a):

First, any other transaction on an exchange by a member for any managed account, affiliated person, or associated person, would not be unlawful "which the Commission, by rule, shall determine contributes to the fair and orderly

¹ Committee on Banking, Housing & Urban Affairs, United States Senate, *Report to accompany S. 249, Securities Acts Amendments of 1975*, S. Rep. No. 94-75, 94th Cong. 1st sess. 67 (Apr. 14, 1975).

² See Comments of the Securities & Exchange Commission on S. 470 and S. 488 to the Committee on Banking, Housing & Urban Affairs, 93rd Cong., 1st sess. 15 (1973).

functioning of the securities markets and which is consistent with the purposes of this paragraph."

Secondly, an amendment offered by Congressman Broyhill of North Carolina was reported in the bill by the House Committee. This amendment cut an exception into the section 11(a) by granting authority to the Commission to permit an exchange member to act as a broker for an account which he manages. The SEC would have been able to exempt any transaction where the member firm only serves as a money manager and is not otherwise affiliated or associated with a person for whom money management services are performed. Provision would also have been required for an independent monitor of trading for the managed account. In our opinion the Broyhill amendment was designed to allow broker-money managers to continue trading for managed institutional accounts, while barring other money managers from equalizing this competitive advantage. It remained in the House legislation, and was part of the bill, H.R. 4111, passed on the floor in April 1975.

As a result of the House's inability to complete work on H.R. 5050 late in the 93rd Congress, the Senate Committee redrafted its bills into one comprehensive package, S. 249. In this process, the SEC's exemptive powers under section 11(a) were expanded so that: "should it appear . . . that any prohibition imposed by Section 11(a)(1) is unnecessary or inappropriate . . . the Commission by rule, would be authorized to remove that prohibition and exempt any transactions of any kind it determines to be consistent with the protection of investors and the public interest. . . . [S]uch broad Commission discretion is appropriate in light of the rapidly changing economic and regulatory patterns affecting exchange trading."

At the same time of the conference to reconcile differences between the House and Senate bills, we wrote each member of the conference urging: (1) deletion of the Broyhill amendment, subsection 105(a)(3)(J), in H.R. 4111, and (2) if the Broyhill amendment were removed, adoption of the provisions in H.R. 4111 as amendment to section 11(a) rather than those in S. 249. The conference committee eliminated subsection 105(a)(3)(J) in its entirety. It also rejected the broad exemptive authority which S. 249 would have given the SEC under Section 11(a), and adopted instead language almost identical to that in H.R. 4111. The conference bill, passed subsequently by both houses of Congress, and signed into law, provides an exemption for "any other transaction of a kind consistent with the purposes of this paragraph, the protection of investors, and the maintenance of fair and orderly markets." The Conference Report of May 19, 1975 stated specifically that exemptions to the prohibitions in section 11(a) should be provided, but only if persons trading have no economic interest in the accounts of associated persons:

[M]ember's trading for accounts of associated persons may under proper circumstances be consistent with the purpose of this section if such persons have no economic interest in such accounts. The SEC therefore should give careful consideration to granting an exemption from the blanket prohibition of section 11(a) to members' trading for all accounts carried in the name of an associated person but in which no associated person has an economic interest and over which no associated person exercises investment discretion."

This is the only instance in which exemptions are encouraged. The conferees cautioned exemptions are to be weighed carefully in light of the Amendments' purpose:

"Accordingly, while the bill makes clear that the Commission has authority to exempt any transactions of any kind from the prohibitions if it determines such exemption is not inconsistent with the protection of investors and the public interest, it makes equally clear that such exemption authority can be exercised only in a manner consistent with the purposes of the general prohibition and these expressions of Congressional intent."

The intent of Congress in amended Section 11(a)(1) seemed clear to us. As the study of this Subcommittee under Chairman Moss emphasized:

"The Subcommittee finds that there is no necessity to require that broker-dealers choose between the brokerage or the money management business. We find, however, that the conflicts are significant enough to warrant amending the Securities Exchange Act to prohibit registered broker-dealers from directly or indirectly performing brokerage transactions for their affiliated accounts. . . . Thus broker-dealers could choose to manage certain accounts with the knowledge that they could not engage in brokerage transactions for those

accounts, while electing not to manage other accounts in the hope that they could obtain brokerage business from them".³

The Senate study, under the leadership of the distinguished Senator from New Jersey, Harrison A. Williams, Jr., was equally concerned about the conflicts of interest when a broker traded for a managed institutional account:

"[T]he question of the combination of money management and brokerage should be resolved by prohibiting stock exchange members and their affiliates from effecting any transactions on national securities exchanges for institutional accounts which they manage. . . . The Subcommittee's proposal would deal effectively with most of the problem . . . problems which result from the combination of money management and brokerage functions.

"1. By eliminating self-dealing . . . the conflicts of interest such as churning, choice of market, appropriate commission level, and dumping, will be eliminated.

"2. This absolute and uniform prohibition on self-dealing will eliminate the problem of market distortion which arises from the different relationships between money management and brokerage allowed by the various exchanges. The incentive to take transactions to the market which affords the opportunity to earn or recapture the most commission income will be removed. . . .

"3. The Subcommittee's proposal applies evenhandedly to all money-managers and will, therefore, provide a fair basis upon which all can compete for money management business. The unjustifiable discrimination suffered by non-broker money managers under the existing arrangements will be eliminated.

"4. The Subcommittee's proposal will eliminate the artificial inducement to money managers to get into the brokerage business. The elimination of this inducement will permit more flexible movement toward the creation of a new central market system without being frozen into current patterns."⁴

In January 1976 the SEC began to question, among other things, the interpretation of "effect" in amended Section 11(a)(1). The Commission proposed an interpretation which would have prevented any broker-dealer from arranging for execution of a transaction with another unaffiliated exchange member. This would have had exactly the opposite effect intended by your own Subcommittee's study: broker-dealers would have been required as a practical matter to choose between the brokerage or the management business. During the summer of 1977, the SEC proposed other interpretations diametrically opposed to its January 1976 release. The only common characteristic between both releases was neither seemed related to the purpose or intent of the 1975 Amendments. Most of the second series of SEC interpretations in 1977 would have nullified any statutory prohibitions against trading for managed institutional accounts.

This Subcommittee, together with Chairman Moss' Subcommittee on Oversight and Investigations, has shown the SEC how to promulgate responsible rules implementing Section 11(a)(1). Your Recent Oversight Report stated:

"Merely arranging for brokerage (as distinguished from actually executing the transaction) is an integral part of the function of managing an account; therefore, to prohibit a member from arranging to have another member perform brokerage for the first member's managed accounts would create such a serious obstacle that the first member would be forced to abandon managing that account, or to withdraw exchange membership."

Your Report recognizes "a primary purpose of Section 11(a) was to place broker-dealers with managed accounts on the same footing as their competitors, such as bank trust departments. . . ." Bank trust departments trade for managed accounts through unaffiliated broker-dealers. Your Report also recognizes "it is permissible under Section 11(a) for an exchange member to arrange for another member to execute transactions which the first member orders on behalf of an account under its management." The Report cautions that brokers must not retain any compensation for making such arrangements, and calls for "regulation and vigorous enforcement action" by the SEC to prevent reciprocal practices to evade Section 11(a). Against the background of thorough and objective study by the House and Senate before passing the 1975 Amendments, and the excellent Oversight Report in 1977, it is

³ Subcommittee on Commerce & Finance, Committee on Interstate and Foreign Commerce, House of Representatives, *Securities Industry Study*, H. Rep. No. 92-1519, 92d Cong. 2d sess. 149 (1972).

⁴ Subcommittee on Securities, Committee on Banking, Housing & Urban Affairs, United States Senate, *Securities Industry Study*, H. Rep. No. 92-1519, 92d Cong., 2d sess. 149 (1972).

difficult to understand why the SEC has not promulgated final regulations. The Commission has had three years to define the word "effect." Surely this is not quite as strenuous or controversial as the SEC suggests. Surely the public has a right to know what to expect May 1, 1978.

The SEC's latest ploy in evading its Congressional mandate is to characterize one of its other directives in the 1975 Amendments as inconsistent with Section 11(a). Section 20A in the 1934 Act [as amended in 1975] directs the SEC to take such steps as are within its power to establish a national market system for transactions in securities. Section 20A states that such a system shall include, as a minimum: a transactional reporting system, a composite quotation system, and a system of rules and regulations designed to provide fair competition. On January 26, 1978, the Commission published a release on the national market system. The release acknowledges the necessity of an intermarket routing system, and a universally available message switch. No specific date for implementation is given. The Commission does say it "is not aware of any reason why both of these facilities should not be implemented by September 30, 1978." In his February 22, 1978 letter to the Speaker of the House and the President of the Senate, the SEC Chairman rationalizes delaying the May first deadline as follows:

"Full implementation of the trading prohibitions of Section 11(a) . . . would be undesirable in light of the continuing rapid pace of economic, technological, and regulatory changes in the markets. . . . This . . . will necessarily be accelerated during the next several months by steps which must be taken to implement the national market system."⁵

Congress was fully aware of the relationship between development of a national market system, and the prohibition on brokers trading for managed institutional accounts. Rather than being inconsistent with a national market system, a prohibition upon exchange members trading for managed institutional accounts was seen by Congress as essential before further progress could occur. The mandate Congress gave the SEC in 1975 was to "remove impediments to and perfect the mechanisms of a national market system for securities." One of the chief impediments is that money managers have been encouraged by the SEC and the Federal judiciary to trade for managed accounts. Congress decided to resolve this question in 11(a), and to do so in an even-handed way which would allow all to compete for the right to manage other people's money on a fair basis. Congress felt so strongly about this that a statutory deadline of May 1, 1978 was written into the law. The SEC was given rulemaking power to implement the prohibition. Eight exceptions were enumerated; the most significant are:

"any transaction for the account of a natural person, the estate of a natural person, or a trust (other than an investment company) created by a natural person for himself or another natural person;

"any other transaction for a member's own account provided that (i) such member is primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, and acting as a broker, or any one or more of such activities, and whose gross income normally is derived principally from such business and related activities and (ii) such transaction is effected in compliance with rules of the Commission which, as a minimum, assure that the transaction is not inconsistent with the maintenance of fair and orderly markets, and yields priority, parity and precedence in execution to orders for the account of persons who are not members or associated with members of the exchange; and

"any other transaction of a kind which the Commission, by rule, determines is consistent with the purposes of this paragraph, the protection of investors, and the maintenance of fair and orderly markets."⁶

In other provisions of the 1975 Amendments, Congress inserted failsafe powers, or granted the SEC discretion to delay deadlines provided it could establish certain findings of fact. Under subsection 6(e)(1)(B) of the 1934 Act, the Commission could have permitted fixed commission rates to continue after November 1, 1976 if the Commission found fixed rates were "reasonable in relation to the costs of providing the service . . . and do not impose any burden on competition."

⁵ Subcommittee on Consumer Protection & Finance, Committee on Interstate and Foreign Commerce, "Oversight of the Functioning and Administration of the Securities Acts Amendments of 1975," Comm. Print No. 95-27, 95th Cong., 1st sess. 10 (1977).

⁶ SEC, "Development of a National Market System" Release No. 34-14416 (January 26, 1978).

The way the SEC has administered its responsibilities under Section 11(a), and its request for an eighteen month extension in the May first deadline will become a heavy burden for the Commission to carry if it intends to perfect the mechanism for a national market system. I am skeptical the New York Stock Exchange will appear on the Commission's doorstep September 30, 1978 to hand over its market linkage and order routing systems for use in the over-the-counter market. Having caused confusion and controversy over Section 11(a) during the past three years, what will the SEC do when it faces hard decisions on the market linkage and order routing systems? Having asked Congress to extend the statutory deadline in Section 11(a), how can the Commission expect anyone to regard its own September 30 deadline seriously? If the Chairman of the SEC believes an eighteen month delay is needed because "several of the commentators on . . . Section 11(a), including the Securities Industry Association, have changed their positions . . . one or more times," what will he propose when he faces an issue of major economic importance to the securities industry, rather than one which interests a relatively small number of brokerage firms? Despite several statements in the transmission to House Speaker O'Neill that full implementation of Section 11(a) will "engender anticompetitive effects that were not, and could not have been, anticipated three years ago," the Commission fails to include one piece of empirical economic evidence to support its claims. If the consequences of implementing Section 11(a) are so grave, it does seem the Commission's economists would have analyzed this problem at some point during the past three years. I have seen nothing in the Commission's material which was not studied with unusual care during evolution of the 1975 Amendments. Chairman John Moss commented at one point in hearings on the 1975 Amendments that "most industries study problems to death, but the securities industry likes to study solutions to death." The Commission appears now to be taking this approach.

The heart of the SEC's current argument is full implementation of Section 11(a) will "put exchange members, and particularly regional and small members, at a severe disadvantage" and will "exacerbate the existing trend towards concentration in the securities industry." We are told:

"Many regional exchange members manage smaller institutional accounts without charging a management fee. Instead, these members rely for their compensation on the brokerage commissions generated by transactions for these accounts. . . . Now that fixed commission rates have been eliminated, if the accounts currently managed by regional exchange members are no longer permitted to obtain money management in return for brokerage compensation alone, many of them are likely to seek to reduce costs by bypassing regional firms entirely."

This scenario is difficult to accept. Our members appreciate the importance of a strong regional broker-dealer network, and recognize their essential position in raising capital. When smaller, regional broker-dealers manage other people's money they are not competing with the Prudential Insurance Company or Morgan Guaranty Trust. Smaller institutional accounts in regional cities usually place a premium upon convenience, geographic location, and prior personal relationships in addition to considering costs and performance. I can't understand why the broker-dealer in Morganton, North Carolina or Tyler, Texas would lose all of its managed accounts to Chicago banks or Boston insurance companies if Section 11(a) were implemented. If the SEC thinks predatory pricing has occurred, or does occur, then the Chairman should turn over evidence to the U.S. Department of Justice for immediate investigation and possible prosecution. Predatory pricing is a serious allegation. It is not something to be tolerated, nor something to be insinuated without actual evidence.

We also believe the beneficiaries of accounts managed by regional brokers would profit by having management charges disclosed, rather than paying for management services through brokerage commissions. Under competitive rates, brokers who manage other people's money have to determine, without the benefit of arm's length bargaining, what constitutes a fair commission charge for transactions executed for managed accounts. It strikes me as odd that the SEC approves of a system under which beneficiaries receive no disclosure of management fees.

Under competitive rates, churning may become a more serious problem for beneficiaries of managed accounts. As profits diminish on each brokerage trans-

action, brokers may seek to increase volume in order to maintain profits. Nowhere would this be more tempting than a managed institutional account over which a broker-dealer has discretionary authority. "Parking" or "dumping" is enticing when broker-dealers manage institutional accounts. Broker-dealers often acquire large blocks of securities in underwritings, block positioning or arbitrage. Occasionally these securities are not sold with the degree of ease anticipated. Institutional accounts are tempting places to dispose of excess securities. Moreover, a broker-dealer could earn a substantial commission in making such a placement.

Section 11(a) (1) merely requires that brokers not profit from orders generated by managed accounts. By requiring captive orders from managed accounts to be effected by independent broker-dealers, Section 11(a) should enhance rather than diminish competition in the securities industry. Economies of scale in the brokerage business are not strong. We see no reason why well-managed broker-dealers in regional cities throughout the United States will not continue to prosper after May 1, 1978. The President of Dain, Kalman & Quail, a capable Minnesota brokerage firm, once answered a question in this area as follows:

"Small, poorly managed, under-capitalized firms in the securities industry will be badly hurt, if not killed, by competitive rates. A lot of small, under-capitalized, badly managed firms are located around the country. If you use that as a description of regional firms, then regional firms will be hurt."⁷

If a brokerage firm would be jeopardized by promulgation of reasonable SEC rules implementing Section 11(a) on May 1, 1978, then the level of its commission rates, and the quality of its service to managed institutional accounts are open to serious question. In one statement, the SEC suggests commission rates are so low there is no longer a profit incentive to join exchanges. In the next statement, the SEC says so many brokers depend upon commission income from managed institutional accounts that our nationwide network of regional firms will be destroyed when Section 11(a) is implemented May 1, 1978. I cannot reconcile those two statements.

Perhaps the most incredible section of the Commission's transmission to the Speaker is a series of arguments that Section 11(a) should not be enforced because it might "lead to a variety of direct and indirect reciprocal practices by which . . . exchange member[s] . . . could recapture the economic benefit of brokerage revenues paid to unaffiliated members." The SEC states "member firms deal with each other in so many different ways that it may be impossible in many cases to enforce any prohibition on reciprocity." It suggests "a substantial portion of the Commission's resources will have to be devoted to enforcement action under Section 11(a)," and its "enforcement efforts may be severely hampered by parties who choose to litigate."

Is this the same agency which told the House Agriculture Committee recently that it could do a better enforcement job than the Commodity Futures Trading Commission, and should be given jurisdiction over a substantial portion of futures trading? Is this the same agency which captures headlines with its investigations of Bert Lance, Tongsun Park, and the President's own nominee to head the Federal Reserve System? Is this the same agency which used the Federal securities laws to highlight the problem of foreign payments? Is it the agency with which the largest corporations in the United States, if not in the free world, sign consent decrees rather than face litigation? Wasn't the SEC the agency which stopped "give ups" in the sale of mutual funds? The SEC's reasoning is so unconvincing one wonders why it is advanced. Perhaps the intent is to promote a larger budget authorization for the Enforcement Division.

In 1975 Congress directed the SEC to stop broker-dealers from trading for managed institutional accounts on May 1, 1978. Since President Ford signed the bill into law, the SEC has generated controversy and confusion throughout the investment community over the appropriate way to implement the statute. The SEC's administration of Section 11(a) raises serious questions about its willingness to implement national policy written by the people's elected representatives in Congress. We oppose the SEC's request for an eighteen month delay. We respectfully request the Congress to admonish the SEC to implement and enforce the law on May 1, 1978 in the reasonable way suggested by

⁷ Subcommittee on Securities, Committee on Banking, Housing & Urban Affairs, United States Senate, *Securities Industry Study*, 93d Cong., 1st sess. 53 (February 1973).

the House Oversight Report in 1977. The Commission has more than sufficient authority to deal with any unanticipated problems which may arise after May 1, 1978.

Mr. ECKHARDT. Mr. Broyhill.

Mr. BROYHILL. Thank you, Mr. Chairman.

Sometimes I think we all look back to where we were when we started out with some of these issues and see what some of them were, at that time and what has happened, and maybe view what we all do in context of where we are today and where we came from.

Of course, I recall back a few years that a number of you were in here complaining about the competitive disadvantage that you were in at that time and particularly with the system of fixed rates. Is it true that negotiated rates have saved your consumers that you represent millions of dollars?

Mr. CASEY, can you answer that?

I mean, this allegation has been made, that negotiated rates have saved millions.

Mr. CASEY. Certainly, they have saved transaction charges, but to get how much it has saved would depend on knowing what the transactions were and how long they took. We have found that rates have never been standard through this 3-year period, that depending on the kinds of transaction there has been a wide range of rates. We have tried to look at them internally and there are transactions in which the commissions would be relatively comparable to what it had been in April 1975, in certain cases, and in other cases, transactions would be a matter of several cents a share.

We have never tried to fix rates. Our own internal policy has been based on assumptions that we do not know what brokers' costs are, and that the broker/dealer industry, through competition, would have to fix those rates themselves, and would be based on their costs and difficulties. I remember Commissioner Loomis once saying he saw no better way of fixing rates than having competition. He certainly couldn't see how the SEC had any crystal ball on what the correct rates would be, and I suspect that maybe in some ways, on transactions in securities of smaller companies, the rates have stayed the same, the spreads have stayed the same, or maybe gone up where there has been fewer brokers interested in smaller companies.

In larger companies, where there is a relatively large float and very easy execution, of course, there has been an almost nominal commission in comparison with what there used to be. This is a thing which regional brokers are able to do equally well. Our experience, getting feedback from our different offices, is first of all, that securities are held locally and that there are settlements, the settlement of transactions is to be local, the transfer of securities against cash. They can compete as well in that aspect of the transaction and probably better than a national brokerage firm. A lack of "fails" is more likely if you have brokerage firms that are on the spot.

Mr. BROYHILL. I don't mean to interrupt—it is not my policy to interrupt—but you are not answering the question.

Mr. CASEY. I am trying to. I don't know the specifics in terms of dollars.

Mr. BROYHILL. The change from fixed commission rates to negotiated rates, has this not saved a considerable amount for the consumers that you represent?

Mr. CASEY. I would think so.

Mr. BROYHILL. And can you document that in any way for the entire industries that you represent?

Mr. CASEY. Not without knowing what the turnover would be. But it would be possible, certainly, to take discount figures or cents per share measured today against 1975.

Mr. BROYHILL. But it is a considerable amount of money when you take it over a year's period of time, is it not?

Mr. CASEY. Certainly, as to large listed securities, yes.

Mr. BROYHILL. Mr. Silver indicated that there is no longer any incentive for your people to join exchanges. Do all of you agree with that because the rates are much lower?

Mr. CASEY. I think I touched on that critical point about litigation.

Mr. BROYHILL. I understand that part.

Mr. CASEY. And so from that point—

Mr. BROYHILL. The reason I am asking—the panel yesterday indicated that they wouldn't care if you joined exchanges. That is the reason I am asking the question. I don't really know that that is an issue here, but do you feel that you can save money by joining an exchange?

Mr. CASEY. Well, one of the SEC staff once came to see us and said what he saw as the correct role for an institution was to provide nonprofit brokerage services for all of its customers. He did not seem to have any awareness of the capital commitment that would be required or concern about the effect on the market system of transactions which would occur in that way. I think that is one of the factors which all of us are troubled about.

Another factor in this whole thing is, how much can be saved? We don't know what costs are. We don't know what profits are on different kinds of transactions. We do know there has been a recent discussion of raising rates by various brokerage firms and if their costs warrant it, probably that would occur. Rates have gone down and will probably go up and down over periods of time. If there were substantial profit in certain kinds of transactions would there be a fiduciary obligation to go and recapture that? That is one of the issues they are now settling at the SEC and the antitrust division about underwritings commission recapture—which would have a bigger effect on regional brokers than anything else—the removal of that fixed commission, if you will.

I don't know, if this proposal were truly for a delay in order to complete rulemaking, I don't think any of us would have an objection. If they were asking for 90 days or something like that in order to complete the rules which they were trying to draft in order to protect certain aspects of the brokerage community—but one of the things that troubled me most about the release was this throw-away in which they would open up institutional membership by a grandfather clause as to all persons who join exchanges prior to November 1979—which would suddenly require every bank, insurance company, investment company and investment adviser to look seriously at whether they ought to have a membership during

that period of time. That kind of thoughtless proposal, without any attempt to focus on the effect on the markets of opening up or even inducing banks and insurance companies to become members is like throwing fuel on the fire.

Mr. BROYHILL. Mr. Vinyard, you made the allegation, or you were answering the allegation—let me put it that way—that was made yesterday—that there is tremendous potential for harm to the small regional firms, in particular. Assuming that the SEC's request is honored, is there any potential for harm, competitive disadvantage for your member firms or any of the other firms that are represented at the table?

Mr. VINYARD. Let me try to answer that question by also responding—

Mr. BROYHILL. What competitive disadvantage would you be put in?

Mr. VINYARD. Could I try to answer your question to Mr. Casey also, on commissions?

Mr. BROYHILL. Certainly.

Mr. VINYARD. I don't think there has been any question, at least for our membership, there has been a saving from unfixing of commission rates. It is difficult to come in with a dollar figure because different insurance companies deal with different broker dealers, different transactions. My impression was that the SEC was supposed to report annually on the results of unfixed commission rates and perhaps they have some data on it. I think that when you look at the question of competition, figures I have seen are that bank trust departments have the greatest proportion of the business of managing outside money. Everybody else is, I think, relatively small in comparison to trust departments of commercial banks. Institutions weren't the ones that initiated the idea in 11(a) of barring people from this or that. I believe that came from the Securities Industry Association. They were so concerned about having institutions on Exchanges that they said we have got to have a prohibition.

There is a great philosophical belief, in our membership, which Mr. Casey shares, that the prohibition on trading for managed institutional accounts is a wise prohibition and we support it as something that is good for the equity markets regardless of how it affects us or mutual funds or broker dealers. The investment people in our membership believe it is something that should be done to build investor confidence to come into the market, whether they come in through broker dealers, or insurance companies, or bank trust departments. I don't believe bank trust departments were members of exchanges when 11(a) was written.

As far as the competitive harm to us, our members in comparison to some other people, don't have that much outside money under management. I have never seen a breakdown comparing property casualty companies with broker dealers—it might be an interesting one.

I think the question was raised yesterday as to whether we have a competitive advantage from selling insurance that brokers don't have. This is an area that has been studied many times in the Congress in different committees. I have never seen any indication there was an advantage.

Mr. BROYHILL. You have never heard of the allegation that has been made when some of your people lend money they get to sell some insurance at the same time?

Mr. VINYARD. When our people lend money they are usually buying stocks and bonds that are traded in public markets.

Mr. BROYHILL. You don't believe that has ever been done?

Mr. VINYARD. I am not aware of it, no.

Mr. BROYHILL. It has been done to me.

Mr. VINYARD. It may have been but I am not aware our members have ever loaned you any money.

Mr. BROYHILL. You are very naive. It is done every day.

No other questions.

Mr. ECKHARDT. Mr. Vinyard, you are saying that you philosophically support the immediate implementation of 11(a). But setting that aside, I think Mr. Casey indicated a moment ago, if a delay were proposed merely for the purpose of permitting time for putting into effect rules creating a degree of certainty in its application, that he would not object to it. I think that is a fair statement. I think you mentioned 90 days.

Do you join in that view, Mr. Vinyard?

Mr. VINYARD. We would support any reasonable attempt to resolve this issue. What concerns our members is it has taken 3 years, and now the SEC is asking for another 18 months.

Mr. ECKHARDT. Well, that is water under the bridge and I guess there is no way to retrieve it, and I do recognize that much of the testimony of Chairman Williams seemed to be toward a question as to whether or not 11(a) should be retained at all, so at the end of his testimony, I asked if he were seeking a repeal of 11(a) at which point he said, no, that he was certainly not. He said that rather strongly.

Now, it certainly is true that the broker dealers that testified before us stated they thought there was no need for 11(a), but if we were to narrow this question somewhat, we may not really have disagreement with respect to this bill except to its time.

Mr. VINYARD. Could I ask you a question in turn? I think our support may depend on what the impact would be in the markets. For example, if May 1 comes and goes, and there are no rules in effect, what happens?

Mr. ECKHARDT. Well, now, the testimony of the broker dealers, which I thought was rather convincing, was that they would have to try to arrange their businesses in ways anticipating the possible effect of a rule. That they would have to take certain action which would cause them to act in areas in which they were not sure of what the final implementation of 11(a) would be, and that they felt that such would have a very adverse immediate impact on the market.

Now, that leads me to another question. If that be true and if there were short time, having extremely marked negative impact on the brokerage market, would that not also hurt insurance companies?

Mr. VINYARD. I am not clear in my own mind, from your statement, what the adverse impact comes from.

Mr. ECKHARDT. Well, that testimony, as I understood it, was that the economic impact of the imposition of 11(a) on the securities

industry would be serious. They said that it would create an impact which would be very marked, at that time. They said they would have to change their way of doing business, they would have to divest themselves of certain of their operations.

Mr. VINYARD. I don't think there is any requirement of divestment. It would just require charging of a management fee. That is the only change they would have to make. I would think that would be a relatively easy one.

Mr. ECKHARDT. Well, some of them seemed to feel they couldn't do business that way. That, presently, certain of their accounts were not large enough to impose a management fee effectively, that they would simply have to do a different kind of business than they are doing now.

I am not saying that is necessarily bad.

Mr. CASEY. That is why I am suggesting the possibility of a temporary rule for a figure like \$150,000. Every account under \$150,000 could be exempted. They have power for that.

Mr. ECKHARDT. That might be true but should they not have some time to adjust to such rule? What we are talking about here, it seems to me right now is whether or not the imposition of 11(a) on a given date with no more notice than that which would be occasioned by the commencement of a rule at the present time, would be too short a period of time for the brokerage industry to adjust to whatever rule goes into effect—perhaps the kind of rule that you are suggesting.

Mr. CASEY. A number of brokers have already, of course, adjusted. Last fall Mr. Garil explained to us that very little of the business of Oppenheimer management was done with Oppenheimer the broker. So there has been plenty of time to adjust, if that is the question.

Mr. ECKHARDT. But that would be true, I think, if 11(a) also provided definitive terms with respect to its application, but the question that was raised yesterday was, and I think you have somewhat touched on it today, that the Commission, itself, has injected some uncertainties as to the effect of 11(a) and those who must act under it felt that they are entitled to know positively how the rule would effect them by the Commission's implementing its application.

Now, it seems to me, that is a pretty valid position. Now, I understand that you would certainly not agree with their philosophic position, some of them who think that 11(a) is not good at all and ought to not go into effect. You take exactly the opposite position, but it seems to me there is perhaps room for agreement that if 11(a) should be put into effect, that the SEC should be under the duty to definitively describe what is considered to be covered and what type of operations the broker dealers could do and what they could not do. It seems to me that is a rather reasonable concern that they expressed yesterday. On the other side, you would not agree with them that 11(a) is not good and shouldn't be put into effect and they would not agree with you, I am sure, that it is good and should be put into effect. I am just trying to find out the areas on which you may agree and which you may not.

Mr. BUNCE. May I comment, Mr. Chairman?

Mr. ECKHARDT. Yes.

Mr. BUNCE. I think, if you go back to the origin of this problem, before negotiated rates and even before volume discounts, many of us who created brokerage subsidiaries did so from a competitive rather than a profit center point of view in order to make things equal competitively. This got the thing started, and we have been through it for many years, and finally, in the 1975 amendments, it would appear that there was *modus operandi*; everybody had been, in effect, forewarned for 3 years hence there would be this divorcement between money management and brokerage. Since then some of the securities industry member firms have, in effect, divested themselves from money management arrangements, some of the insurance companies have, I know, folded up their brokerage subsidiaries recognizing that this was all going to occur. My only concern with another postponement even though, admittedly, maybe the SEC hasn't made it completely clear what the ground rules will be, both the SEC and the securities industry members and the insurance companies and other institutions have all had 3 years, in effect, to plan and see how the thing was going—as I said, some insurance companies have folded up their brokerage subsidiaries. I can't speak for all of them. I don't know all of the facts. I know, in our own case, we have continued to keep ours open although the activity is very limited, but we kept it open because we didn't really know what was going to happen. Ours is from a competitive point of view.

Mr. ECKHARDT. I agree with you that there has been too much time passed with 11(a) in effect without implementation of it, but, of course, we are always faced with trying to create some kind of reconciliation of possible adverse effects on the industry where various elements of the industry may take different views as to the long term effect.

We are, here, in a situation where we are dealing with a relatively short time extension. We are dealing with a portion of money management in which the broker has been engaged for nearly 200 years. Apparently, they are not at too much of an advantage because they seem to have garnered only about 3 percent of that market in that 200 years.

Assuming we determine philosophically that should end with the concerns that brokers engaged in this business management have indicated, what great harm would be done, considering the relatively small segment of the business involved, if an additional period of time were allowed in order for the SEC to make rules and implement 11(a)?

Mr. BROYHILL. That was my question, Mr. Chairman, and I couldn't get an answer from anybody. I gave up. What harm is going to occur to you people if we continue this for awhile?

Mr. CASEY. There would be great harm if the SEC's gratuitous proposal were to exempt all persons that become Exchange members before November 1979.

Mr. ECKHARDT. If the grandfather essentially set aside 11(a)?

Mr. CASEY. Yes.

Mr. ECKHARDT. That would be a harm occasioned by the rule and not occasioned by the extension except that a harm from the rule might be put into effect.

Mr. CASEY. I think they propose that as one of the pieces of legislation. As I read it, they have 3 alternative pieces of legislation. One is to change the effective date to November 1979. The second is to change the grandfather to February of 1978, and the third is to change the grandfather until November of 1979. And maybe part of our confusion is that we have been trying to address all of those.

Mr. ECKHARDT. We did not introduce that. We have introduced this bill by request but we did not introduce the other bill, although requested to do so.

Mr. CASEY. Yes, sir.

Mr. VINYARD. Mr. Chairman, is it possible, in light of the legislative schedule of the House and the Senate this year to have a bill passed by May 1 effecting this area?

Mr. ECKHARDT. Yes, I think so.

Mr. VINYARD. How long an extension would you propose?

Mr. ECKHARDT. Well, we have proposed the 18 months.

Mr. VINYARD. We would be opposed to 18 months.

Mr. ECKHARDT. And you say that 90 days is about the longest it ought to be?

Mr. CASEY. Well, I was saying 90 days with a clear indication that the SEC is to proceed with the section 11(a) policy; 18 months, particularly in light of the SEC's brief, is an invitation for further study and objection by the SEC—back to its old position of institutional membership.

Mr. ECKHARDT. Let's think for a moment in terms of considering 11(a) as the present policy of the Congress, which, of course, it is, and let's think for a moment in terms of an extension. We won't say whether it is 90 days or 18 months, but some extension long enough to promulgate rules and for persons to accommodate their businesses to the rules that may come up.

You raised the question of "churning," "parking," and "dumping." Mr. Vinyard. I think you raised those. Haven't these problems always existed, and can't the Commission whose enforcement efforts you have rather praised as being vigorous, control those within that relatively short period of time?

Mr. VINYARD. I think the problems have always existed and I hope they would control them.

Mr. ECKHARDT. If there are real problems, why is it that those managed accounts which are traditionally most abused, the accounts belonging to individual investors, are exempt from the present proscriptions of 11(a)?

Mr. VINYARD. I believe that was the position of the securities industry when the 1975 amendments were pending, to exempt them, and it must have been felt necessary to do that to arrive at some degree of support for 11(a). It is not something that I think those who are concerned about the area have volunteered.

Mr. ECKHARDT. Mr. Oppen.

Mr. OPPEN. It has been suggested, with the implementation of 11(a), Mr. Casey, there will be a considerable diminishment of some

revenue streams to regional firms which firms are not in a position to generate institutional order flow. Do you have any thoughts on that?

Mr. CASEY. All I can do is look at the way things have worked and, at least, the figures that I have seen and conversations I have had with our members. There generally is very local service for local accounts. That is because, in general, clients of our members have bank custody services where they live or in the location of the offices. That tends to mean that the service that can be best rendered is rendered by local brokers on the smaller size orders, and perhaps I can say something about that.

As far as I can see, our members don't have their accounts walking in lockstep order. The portfolios tend to be tailor made on the smaller size securities orders, for large firms and small. At times, there will be the same security even—for example, IBM might be sold for some accounts and bought for other accounts, reflecting what the concentration or lack of it was in a particular portfolio. Orders tend to be diversified over a period of time and in terms of size. Settlement questions locally can be done often best by people who are on the spot. So I would say, in terms of competition, that regional brokers compete as far as I know very well with national firms on regional accounts.

Mr. BUNCE. My own personal experience is that some insurance companies are more regionally oriented than others. I could try to get the views of other insurance companies on this issue. I would suspect all of us, however, do attempt to do business with regional brokerage firms if they have anything in the form of local contacts or research or something that might be applicable to our activity, and as you know, more and more institutions are creating portfolios and going down the scale in terms of size of companies in which they are investing. I know that we are making a concerted effort to participate more fully through regional brokerage firms for portfolios of that type.

Mr. OPPER. I have no further questions.

Mr. ECKHARDT. Thank you very much for your help to this committee.

The subcommittee will be recessed—let's recess for about 10 minutes, and then we will have the other panel come forward.

[Brief recess.]

Mr. ECKHARDT. All right. We will go forward with our second panel. I think it might be well for you to introduce yourselves and those with whom you have come, at the start. Do you want to start at this end?

Mr. CRAWFORD. I am Donald J. Crawford, head of the SIA Washington office.

Mr. HUNTER. I am David W. Hunter, chairman, Governing Council, SIA.

Mr. SULLIVAN. Joe Sullivan, president of the Chicago Board Options Exchange, Inc., accompanied by Mr. Meyer.

Mr. BIRNBAUM. I am Bob Birnbaum, president of the American Stock Exchange. With me are Justus C. Martin, Jr., governor, AMEX, and president, Robinson-Humphrey Co., Inc., and Norman S. Poser, executive vice president, American Stock Exchange, Inc.

Mr. ECKHARDT. Will you commence, Mr. Hunter?

STATEMENT OF DAVID W. HUNTER, CHAIRMAN, SECURITIES INDUSTRY ASSOCIATION GOVERNING COUNCIL, ACCOMPANIED BY DONALD J. CRAWFORD, VICE PRESIDENT AND DIRECTOR, WASHINGTON OFFICE; AND DAVID E. ROSEDAHL, ASSOCIATE GENERAL COUNSEL AND SECRETARY

Mr. HUNTER. My name is David Hunter. I am chairman of the Securities Industry Association's Governing Council, and I appear here today on the SIA's behalf. With me today are Donald J. Crawford, vice president and director of our Washington office; and David E. Rosedahl, associate general counsel and secretary of the SIA. In my professional affiliation I am president and chief executive officer of Parker/Hunter, a brokerage firm in Pittsburgh, Pa. As you know, the SIA represents approximately 500 leading investment banking and brokerage firms headquartered throughout the United States, which, collectively, account for approximately 90 percent of the Nation's securities transactions conducted in this country. The business of our members includes retail brokerage conducted on behalf of 25 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions, and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels.

We appreciate the opportunity to present the association's views at these hearings. We are here to support the legislation, proposed by the Securities and Exchange Commission and introduced by Congressman Eckhardt, which would delay full effectiveness of section 11(a) of the 1934 act as amended by the Securities Acts Amendments of 1975. We commend the subcommittee for holding these hearings so promptly following the submission of the SEC's request to Congress. These hearings begin the legislative process which hopefully can be completed before the May 1, 1978, effective date for section 11(a).

The SIA continues to believe that the policy embodied in section 11(a) is necessary to preserve and enhance the public nature of the exchange markets. Exchange markets must have the characteristics of fair and open dealing which are most readily preserved if their members have the primary purpose of serving the public as brokers and market makers. Moreover, section 11(a) represents a means of fostering the delicate balance of fair and equal competition between member and nonmember money managers. When I appeared before this subcommittee and the Subcommittee on Oversight and Investigations at joint oversight hearings last July, I traced the administrative and legislative background leading to the enactment of section 11(a) in its present form. I am submitting a copy of that statement and my subsequent letter to Chairman Eckhardt and Chairman Moss along with my written statement today for the record of these hearings. Since July, the subcommittee issued a report* which among other things, expressed the view that—all other questions aside—an exchange member should be free to arrange for

* Oversight of the Functioning and Administration of the Securities Acts Amendments of 1975," report by the Subcommittee on Oversight and Investigations and the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce, 95th Cong., first sess. (Committee Print No. 95-27).

another, unaffiliated, exchange member to execute a transaction on an exchange ordered by the first member on behalf of an institutional account under its management.

Nevertheless, the SIA readily acknowledges that section 11(a) is a complex provision with broad implications requiring careful consideration by exchange members of the scope of activities covered and the manner in which they the conference report accompanying the 1975 amendments.**

We understand that the Commission will continue their efforts to develop appropriate rules and interpretations of the section which reflect the true intent of Congress when section 11(a) was amended in 1975.

In sum, we support enactment of H.R. 11140 at the earliest possible date. I would like to point out that in the limited time we have had to review the legislative proposal, our committee on section 11(a) chaired by Bill Boothby and Blyth Eastman Dillon has met to review the proposal and recommended that the SIA support it. We then polled the 73 members of our Governing Council on the proposal and learned that an overwhelming majority supported it.

That concludes my statement. I would be pleased to answer your questions.

Mr. ECKHARDT. Mr. Sullivan.

**STATEMENT OF JOSEPH W. SULLIVAN, PRESIDENT,
CHICAGO BOARD OPTIONS EXCHANGE, INC.**

Mr. SULLIVAN. Mr. Chairman, Congressman Broyhill. My name is Joseph W. Sullivan, and I am president of the Chicago Board Options Exchange. I am pleased to be here to discuss why we believe it is necessary to delay the effectiveness of section 11(a)(1) of the Securities Exchange Act of 1934.

Most of the previous witnesses, including the SEC, must comply. We had hoped that by this time the Commission would have published appropriate rules and interpretations so that we as businessmen could plan for the implementation of the section. The Commission, while making a good faith effort to provide the necessary administrative guidance for implementation consonant with congressional intent, has been unable to reach that goal. Rather, the Commission has determined that a number of factors militate against the full implementation of the section on May 1 of this year including the "premature application of the section to the securities markets at a time when they are undergoing substantial evolution."*** Further, the Commission has noted that substantial interpretative ambiguities have arisen and that "(i) in view of the extensive controversy over the scope and application of section 11(a), exchange members have not been able to take full advantage of the statutory delay originally provided by Congress to prepare for full effectiveness of section 11(a)."

** See memorandum of the Securities and Exchange Commission in support of its recommendation that the Congress delay the full effectiveness of section 11(a) until Nov. 1, 1979, p. 6.

*** Also, the exemption, provided by the Labor Department and IRS, from the prohibited transactions of ERISA to permit securities firms to continue to provide brokerage services to accounts with respect to which they exercise investment discretion expires on May 1, 1978.

Since we are approaching May 1, 1978, with a number of these important questions unresolved, the SIA supports the proposed delay as a means of allowing the industry to prepare in an orderly fashion for the implementation of Section 11(a). Furthermore, the Labor Department and the Internal Revenue Service must know the final contours of section 11(a) in order to conform the prohibitions of ERISA pursuant to have focused on the impact of section 11(a) in separating brokerage from money management. That is a very important issue, but there are other issues embodied in section 11(a) which are also very important to the operation of the nation's exchanges in general and our reasons for supporting the legislation that would delay the effectiveness of section 11(a) are not addressed in the first instance to the money management separation so much as the restrictions upon proprietary trading by exchange members. We believe it would have several adverse consequences for the orderly operation of exchange markets and CBOE's market in particular. It is on this basis that we support H.R. 11140 and would hope moreover that the extension would not just be applicable to those pre-1975 exchange members who are currently exempted from its provisions, but also that an extension of 11(a), at least those provisions applicable to proprietary trading members, should be applicable to all exchange members present and future. Simply extending the present exemption for a longer period of time, or to an additional category of members, while at the same time requiring that other more recent members be subject to section 11(a), would do nothing to eliminate the problems that the section poses for our market but would continue to subject us and all other exchanges to these problems, albeit with respect to a different group of members.

Our difficulty with section 11(a) centers around the requirement that, absent a specific exemption or an exemption provided by Commission rule, proprietary transactions of exchange members or their affiliated persons are illegal. We believe that such a provision is not necessary in order to protect public investors, especially in a market such as ours that already gives priority to the orders of public customers. We also find completely unworkable in our market the statutory exemption set forth in subsection (G) of section 11(a)(1) for transactions for a member's own account, provided the member is primarily engaged in a public securities business and the transaction yields priority, parity, and precedence to transactions of nonmembers. Finally, we believe that the application of section 11(a) to exchange members would represent a strong disincentive to membership that would greatly limit the scope and quality of exchange self-regulation. To convey why we hold to these beliefs, I hope you will permit me a minute just to portray how the Chicago Board Options Exchange market is structured and how it functions.

CBOE presently has in place a functioning system for providing meaningful priority to nonmember orders that we believe goes further than anything found on other exchanges. On CBOE, the traditional specialist's agency and dealer functions are divided, with the former being assigned to a single specialist-broker, called a board broker, and the latter being the responsibility of a large group of specialist-dealers that act as competing marketmakers. The

board broker maintains a book of limit orders that, with very limited exceptions, have priority over other bids and offers in the crowd at the same price, regardless of time of entry. No exchange member is permitted to place an order with a board broker for its own account or for the account of any other member, and we expect soon to implement a rules change that will prohibit a board broker from accepting an order for the account of any broker or dealer, whether a member or not. Thus on CBOE, the priority given to orders held by the board broker is available only to nonmember public orders, and soon this priority will be available to public orders of non-broker or dealers.

We have long believed that our approach to public order priority could serve as a model for other exchanges and we are pleased to see that the Commission, in its recent release entitled "Development of a National Market System" has indicated that one of the basic features of a national market system should be a central limit order file for public agency orders. As stated in the Commission's release, once such a mechanism is in place, public limit orders—defined as "any limit order not for the proprietary account of a broker or dealer—can be assured of receiving an execution prior to the execution of any other order by a broker or dealer in any market at the same or an inferior price." In our view, this approach to public order priority, which is comparable to the approach we have taken since we first commenced operations in April 1973, is more meaningful, easier to enforce, and far less disruptive to the market than the requirement of subsection (G) of section 11(a)(1) that member orders yield priority, parity, and precedence to nonmember orders.

The unworkability of subsection (G) reflects, in our view, a failure to take into account the realities of the trading floor environment, especially where, as in our market, there are competing marketmakers. As I previously mentioned, on CBOE there is no single repository of bids and offers, but instead there are numerous individual marketmakers entering bids and offers in each options series, plus a board broker handling the book of public limit orders. In addition, because marketmakers are not permitted to represent any agency orders, and because certain types of orders cannot be held by the board broker, there are also a great number of brokers in each trading crowd bidding and offering on behalf of customers. Typical trading crowds on CBOE include 8 to 10 marketmakers, 4 to 6 floor brokers, plus the board broker, and considerably larger trading crowds are not uncommon. These numerous market participants may be bidding and offering simultaneously, some on behalf of members' orders, some on behalf of associated persons' orders, and some on behalf of nonmember orders. In such a market, the consequence of requiring member orders to yield priority other than to our board broker would be total chaos, since it would be necessary to stop the auction each time a trade was proposed to be executed in order to determine the priority of all of the would-be participants, taking account of the status of the initiating parties and the times of order entry.

Finally, and skipping a bit of the statement, to the extent that section 11(a) applies only to members of national securities ex-

changes, and no comparable requirement applies to nonmember brokers or dealers, section 11(a) establishes a strong disincentive to exchange membership, with a number of undesirable consequences. As exchange members choose to give up their memberships and conduct business "upstairs," the continued ability of the exchanges to provide the self-governance and surveillance necessary to maintain fair and orderly markets will be seriously impaired, since the exchanges will lose regulatory jurisdiction over their former members, and will also lose important sources of revenue needed to sustain their regulatory efforts.

Thus even apart from questions raised by the Commission concerning present and proposed changes in exchange markets that no longer make it appropriate to apply section 11(a) to exchange members generally, if indeed its application ever was appropriate, we have attempted to describe other reasons why we believe it is imperative to defer the application of section 11(a) to the proprietary transactions of exchange members. We urge that this be done with respect to all exchange members, including those that might become members in the future, by extending for all purposes the date when section 11(a)(1) becomes effective.

Thank you very much.

[Mr. Sullivan's prepared statement follows:]

STATEMENT OF JOSEPH W. SULLIVAN, PRESIDENT, CHICAGO BOARD OPTIONS EXCHANGE, INC.

My name is Joseph W. Sullivan, and I am President of the Chicago Board Options Exchange. I am pleased to be here to discuss why we believe it is necessary to delay the effectiveness of Section 11(a)(1) of the Securities Exchange Act of 1934.

We agree with the position of the Securities and Exchange Commission that under present circumstances, the application of Section 11(a) would have many adverse consequences. While not all of the objections to Section 11(a) that are set forth in the Commission's recent memorandum on the subject would apply to CBOE or its members, Section 11(a) presents other serious difficulties for our market which we shall describe in this statement. For these reasons, we support legislation that would delay the effectiveness of Section 11(a). However, we do not believe that it would be sufficient merely to extend the time when Section 11(a) would become effective with respect to pre-May 1975 exchange members who are currently exempted from its provisions, as H.R. 11140 nor would it be sufficient to extend an exemption to current post-May 1975 nonexempt members, as the alternate bill proposed by the Commission would do.

Instead, we believe that Congress must be prepared to defer the application of section 11(a) with respect to all exchange members, present and future. Simply extending the present exemption for a longer period of time, or to an additional category of members, while at the same time requiring that other more recent members be subject to Section 11(a), would do nothing to eliminate the problems presented by the section, but would continue to subject us and all other exchanges to these problems, albeit with respect to a different group of members.

Our difficulty with Section 11(a) centers around the requirement that, absent a specific exemption or an exemption provided by Commission rule, proprietary transactions of exchange members or their affiliated persons are illegal. We believe that such a provision is not necessary in order to protect public investors, especially in a market such as ours that already gives priority to the orders of public customers. We also find completely unworkable in our market the statutory exemption set forth in subsection (G) of section 11(a)(1) for transactions for a member's own account, provided the member is primarily engaged in a public securities business and the transaction

yields priority, parity and precedence to transactions of nonmembers. Finally, we believe that the application of Section 11(a) to exchange members would represent a strong disincentive to membership that would greatly limit the scope and quality of exchange self-regulation.

CBOE presently has in place a functioning system for providing meaningful priority to nonmember orders that we believe goes further than anything found on other exchanges. On CBOE, the traditional specialist's agency and dealer functions are divided, with the former being assigned to a single specialist-broker, called a board broker, and the latter being the responsibility of a large group of specialist-dealers that act as competing marketmakers. The board broker maintains a book of limit orders that, with very limited exceptions, have priority over other bids and offers in the crowd at the same price, regardless of time of entry. Size is not a factor in determining priority of orders in the board broker's book. No exchange member is permitted to place an order with a board broker for its own account or for the account of any other member, and we expect soon to implement a rules change that will prohibit a board broker from accepting an order from any broker or dealer, whether a member or not. Thus on CBOE, the priority given to orders held by the board broker is available only to nonmember public orders, and soon this priority will be available only to public orders of nonbroker or dealers.

Our board broker system works to provide public order priority, as contrasted with the unworkable approach taken in subsection (g) of section 11(a) (1), because under our system attention need be focused in only one place: if a board broker is displaying the highest bid or lowest offer, that bid or offer has priority over all other orders at the same price, and reference need not be made to other orders in the crowd.

We have long believed that our approach to public order priority could serve as a model for other exchanges, and we are pleased to see that the Commission in its recent release entitled "Development of a National Market System" has indicated that one of the basic features of a national market system should be a central limit order file for public agency orders. As stated in the Commission's release, once such a mechanism is in place, public limit orders (defined as "any limit order not for the proprietary account of a broker or dealer") "can be assured of receiving an execution prior to the execution of any other order by a broker or dealer in any market at the same or an inferior price."¹ In our view, this approach to public order priority, which is comparable to the approach we have taken since we first commenced operations in April 1973, is more meaningful, easier to enforce, and far less disruptive to the market, than the requirement of subsection (G) of section 11(a) (1) that member orders yield priority, parity and precedence to nonmember orders.

The unworkability of subsection (G) reflects, in our view, a failure to take into account the realities of the trading floor environment, especially where, as in our market, there are competing marketmakers. As I previously mentioned, on CBOE there is no single repository of bids and offers, but instead there are numerous individual market-makers entering bids and offers in each options series, plus a board broker handling the book of public limit orders. In addition, because marketmakers are not permitted to represent any agency orders, and because certain types of orders cannot be held by the board broker, there are also a great number of brokers in each trading crowd bidding and offering on behalf of customers. Typical trading crowds on CBOE include 8 to 10 marketmakers, 4 to 6 floor brokers, plus the board broker, and considerably larger trading crowds are not uncommon. These numerous market participants may be bidding and offering simultaneously, some on behalf of members' orders, some on behalf of associated persons' orders, and some on behalf of nonmember orders. In such a market, the consequence of requiring member orders to yield priority would be total chaos, since it would be necessary to stop the auction each time a trade was proposed to be executed in order to determine the priority of the would-be participants, taking account of the status of the initiating parties and the times of order entry. Such a trading procedure would be cumbersome enough on any exchange. Applied to CBOE's system of multiple competing marketmakers, with a separate individual handling the limit order book, any effort to enforce such a provision would likely grind the market to a halt. There are simply too many participants and too many transactions to be able to

¹ Securities Exchange Act Release No. 14416, 1110-1111 (Jan. 26, 1978).

classify and rank each order represented in a crowd. We and other exchanges have already had to confront this problem to the extent that Section 11(a) now applies to post-May 1975 members, and so far as I am aware, no exchange has found a solution. It is to avoid these kinds of unenforceable provisions now and in the future that we urge Congress to defer the effectiveness of Section 11(a) as to all members, and not just to certain categories of members.

Finally, to the extent that section 11(a) applies only to members of national securities exchanges, and no comparable requirement applies to nonmember brokers or dealers, section 11(a) establishes a strong disincentive to exchange membership, with a number of undesirable consequences. As exchange members choose to give up their memberships and conduct business "upstairs," the continued ability of the exchanges to provide the self-governance and surveillance necessary to maintain fair and orderly markets will be seriously impaired, since the exchanges will lose regulatory jurisdiction over their former members, and will also lose important sources of revenue needed to sustain their regulatory efforts. CBOE especially appreciates the enormous cost involved in providing surveillance over an exchange market since, as a new exchange in 1973, it had to create from scratch a large-scale regulatory and surveillance system in a very short period of time. In fiscal 1977, only four years after it first opened, CBOE spent close to \$3 million, representing 25 percent of its total budget, on regulation. This included the cost of maintaining 100 persons devoted to regulation, and it also included over \$500,000 and equipment. As a result of these expenditures, CBOE believes that its spent on the development and operation of automated surveillance programs surveillance and regulatory system is one of the most sophisticated anywhere. Without the dues and transaction fees of its members, it would be impossible for CBOE to continue to provide this level of regulation over its market. Of course, the other side of the coin of applying section 11(a) only to exchange members is that those brokers and dealers who remain as members would be placed at a serious competitive disadvantage vis-a-vis nonmembers, whose trading activity would not be limited by section 11(a).

Thus even apart from questions raised by the Commission concerning present and proposed changes in exchange markets that no longer make it appropriate to apply section 11(a) to exchange members generally, if indeed its application ever was appropriate, we have attempted to describe other reasons why we believe it is imperative to defer the application of Section 11(a) to the proprietary transactions of exchange members. We urge that this be done with respect to all exchange members, including those that might become members in the future, by extending for all purposes the date when section 11(a) (1) becomes effective.

Mr. ECKHARDT. Mr. Birnbaum.

STATEMENT OF ROBERT BIRNBAUM, PRESIDENT, AMERICAN STOCK EXCHANGE, INC., ACCOMPANIED BY NORMAN S. POSER, EXECUTIVE VICE PRESIDENT; AND JUSTUS C. MARTIN, JR., PRESIDENT, ROBINSON-HUMPHREY CO., INC.

Mr. BIRNBAUM. I am Bob Birnbaum, president of the American Stock Exchange. The American Stock Exchange supports the proposal of the Securities and Exchange Commission to delay until November 1, 1979, the full effectiveness of section 11(a) of the Exchange Act and urges Congress to take action on this before May 1, 1978.

The exchange takes this position for three reasons:

First, the changing structure of the markets makes it particularly necessary for the SEC to reconsider how best to implement section 11(a).

Second, if section 11(a) goes into full effect on May 1, 1978, as scheduled, it is likely to have a severe adverse impact on exchange markets and exchange members.

Third, section 11(a) will operate in an unfair discriminatory fashion against exchanges in relation to other markets for listed securities and against exchange members in relation to nonmember broker-dealers.

In short, we believe that additional time is needed to decide whether regulatory action should be taken to alleviate these problems before section 11(a) becomes fully effective.

I would like to discuss each of these points briefly.

RESPONSE TO CHANGING CONDITIONS

A review of the legislative history of section 11(a) makes clear that the provision was a response to pressures from institutional investors for exchange membership. These pressures in turn came largely from the fixed commission rate system. Ironically, section 11(a) was enacted just at the time when the fixed commission rate, which gave rise to it, was on the way out. Today institutions have economic access to the exchange markets, and the pressures for institutional membership are much reduced.

Furthermore, as the Commission has stated in its memorandum supporting its proposal to postpone effectiveness of section 11(a), the development of a national market system raises questions concerning implementation of section 11(a) which may not have been fully considered in 1975 when the provision was enacted. It is not at all clear how section 11(a) would operate in a national market system. For example, where orders are routed between market centers, a particular order may or may not be covered by section 11(a), depending on whether it is executed on an exchange, and on whether the broker involved is a member of that exchange. In fact, it may not even be clear, in a national market system, what is the place where an execution occurs.

In view of these changing conditions, and particularly the experience under negotiated rates and the current efforts to develop a national market system, we urge that the full effectiveness of section 11(a) be delayed. It doesn't seem like a major request when you remember that Congress itself figured that there would be numerous difficulties in implementing the amendments to section 11, and made its effective date for the old members on May 1, 1978. It seems that the Commission's request for another 18 months is not unreasonable. Moreover, we believe that both Congress and the Commission may find it necessary to review the underlying rationale of section 11(a) as the national market system evolves.

ADVERSE IMPACT

An important, and we believe unintended, result of section 11(a) is that it would greatly reduce the ability of exchange members to trade on the exchange for their own account. While certain types of members' trading are exempted under section 11(a)(1), others are not. Notably, floor trading, which the Commission has found serves to add depth, liquidity and orderliness to the trading markets, would be largely prohibited under the Commission's current interpretation of section 11(a). This is because most Amex floor traders

do not do a predominantly public business and therefore cannot avail themselves of the exemption for members' trading provided by section 11(a)(1)(G). Furthermore, despite the plain language of section 11(a)(1), the Commission has taken the position that an individual exchange member, unlike an individual associated with a member or a discretionary customer, is not a "natural person" and therefore cannot avail himself of the exemption provided by section 11(a)(1)(E).

Floor trading was the subject of close scrutiny by the SEC for many years and in 1964 the Commission adopted rule 11a-1, which imposed strict regulation to avoid conflicts of interest, and to insure that floor traders' activities contribute to the exchange markets and that traders are not able to use their proximity to the markets to take unfair advantage of the public. These regulations are currently in effect and we believe that this system of regulation is working well.

The detailed hearings that led to the 1975 amendments did not disclose any abuses by floor traders nor did the congressional reports contain any suggestion that regulated floor trading should be abolished. We do not believe that the public interest is served by abolishing a legitimate regulated activity without any evidence that this activity is the cause of wrongdoing or abuse.

We have written to the Commission on several occasions requesting that it adopt a rule under section 11(a)(1)(H) which would exempt members' trading which serves to enhance the liquidity of the markets. We have also requested that the Commission reconsider its interpretation of the "natural person" exemption. We believe that it would be in the public interest to delay the effectiveness of section 11(a) so that the difficult problems of interpretation and the appropriate exercise of rulemaking authority can be resolved in an orderly fashion.

DISCRIMINATORY EFFECTS

Probably because section 11(a) grew out of the institutional membership controversy, it applies by its terms only to activities on an exchange by members of that exchange. Thus, a member of an exchange would not be covered by the prohibition of section 11(a)(1) if he trades, either for a proprietary account or a managed institutional account, on another exchange of which he is not a member or in the over-the-counter market. Furthermore, a nonmember of an exchange is not restricted in any way by section 11(a)(1) in his trading for proprietary or managed accounts.

The discriminatory impact of this selective ban is obvious. In a period when increased emphasis is being given to competition among broker-dealers, market makers and market centers, the exchanges and their members are bound to suffer unfairly from the operation of section 11(a)(1).

Because nonmembers are not covered by section 11(a)(1), it is likely to be a disincentive to exchange membership. Negotiated commission rates have already greatly reduced the economic incentives of broker-dealers to remain members of exchanges and submit themselves to exchange self-regulation; section 11(a) would reinforce this disincentive. We believe, therefore, that the Commission should

be given additional time to consider whether it should exercise its rulemaking power to assure that section 11(a), when it goes into full effect, applies evenhandedly to all markets and all broker-dealers.

Finally, I would like to comment on the phasein provisions of section 11(a). The SEC has submitted two proposals. The American Stock Exchange strongly favors the alternate proposal submitted, which would provide that only new Exchange members after February 1, 1978, would be covered.

We believe that this approach has the advantage of keeping within a narrow scope the anticompetitive aspect of having two classes of Exchange members, one covered by section 11(a) and the other not. Furthermore, we think that this approach will involve the least likelihood that the markets will be adversely affected during the interim period. Thank you.

Mr. Justus Martin would like to make a brief statement.

STATEMENT OF JUSTUS C. MARTIN, JR.

Mr. MARTIN. Mr. Chairman, Mr. Broyhill, I am Justus Martin, president of the Robinson-Humphrey Co., domiciled in Atlanta, Ga.

Implementation of section 11(a) would put member firms at a distinct competitive disadvantage to nonmember money managers such as banks and investment counselors. The disadvantage would come at a time when the exchange community is already under great economic pressure as a result of the advent of negotiated rates. Institutional commission business for most regional firms has been drastically reduced, and the typical regional firm has had to seek other sources of revenue. To put them at a disadvantage in the area of money management at a time when they are struggling for economic viability would be one more step in the direction of forced consolidation and contraction in the investment banking industry. If section 11(a) were effected, the small and the regional firm would not only be at a disadvantage to the nonmember money manager, but also to the larger member firms who would charge a fee but because of the size of their transactions could negotiate bare minimum brokerage rates with unaffiliated exchange members. Thank you.

Mr. ECKHARDT. Mr. Broyhill.

Mr. BROYHILL. Thank you, Mr. Chairman.

I was interested in your statement, Mr. Sullivan, about the problems that would occur if 11(a) were implemented, the issue you brought up here that hasn't been brought up before. As I understand the problem is that you will have, in your trading crowd, a number of member orders, and there may be member orders that are transacted, and that you have no way to determine if these are member orders and how to figure out what other public member orders give priority. Is that the problem?

Mr. SULLIVAN. You have stated it very precisely.

Mr. BROYHILL. Is it a common occurrence that members are trading for their own accounts?

Mr. SULLIVAN. Oh, yes, in the CBOE market.

Mr. BROYHILL. Do you have any idea as to what extent it is now? Is it 5 percent of the market, 10 percent, or does it vary from time to time?

Mr. SULLIVAN. The distribution of participation in our market, about half the total volume is accounted for by our market makers who are performing the market making function on our exchange. About 45 percent is accounted for by customers, nonmember customers, nonmember customers, though some of them may be broker-dealers, and about 5 to 6 percent is accounted for by proprietary transactions of members and virtually all of the large member firms that are engaged in, for example, block positioning, are using the options to hedge in connection with their stock positioning activities. All of the large brokerage firms that are engaged in proprietary trading—arbitrage and other trading activities—are participants in the options market to one extent or another, and in an active trading situation, you can have as many as 8 or 10 brokers holding orders. One broker may be holding some kind of customer orders which can't go to our board broker book because that is only for pure limit orders, and there are discretionary orders, not-held orders, what we call spread orders.

You have 10 people in a crowd bidding an eighth. If every time an order came in at an eighth, you had to hold every one of them to determine what kind of order it was before you would have a transaction, it would grind our market to a halt.

Mr. ECKHARDT. Do you have the same problem?

Mr. BIRNBAUM. We do have a similar problem, as Mr. Sullivan has brought out. We have also, over the past 2 years, brought this up with the SEC.

Mr. BROYHILL. You indicate that you have no solution to this problem. You haven't studied it and tried to figure out some way to solve this problem? I am sure you understood what the committee was after at the time?

Mr. SULLIVAN. We have sought ways in which it could possibly be implemented in our crowd, but frankly, we directed our efforts, as with AMEX, to urging upon the Commission rulemaking that would alleviate that situation and are hopeful that the pending rules proposal before the Commission may yet be adopted that would avert the virtually unworkable effects of this provision.

Mr. BIRNBAUM. We have put in a system to try and deal with this, but I think one of the problems is while you may be able to put a tremendous effort in and deal with the limited number of people, now, because it is only applicable to people who joined since May 1, 1975, if it becomes fully effective, as time goes on the system we now have in place will probably not be effective when we are dealing with large numbers of participants rather than the small number we are now dealing with.

Mr. BROYHILL. No other questions.

Mr. ECKHARDT. I gather Mr. Sullivan and Mr. Birnbaum, that both of you really see no particular merit in 11(a) per se?

Mr. SULLIVAN. I don't profess to have given enough study to the whole broker money management separation issue to personally

render a bottom line judgment from the standpoint of CBOE as an exchange.

Mr. ECKHARDT. But you raise questions about its practicability?

Mr. SULLIVAN. As to its application to the proprietary trading of members, I would hope very much that it could be at least amended, if not repealed, in that respect.

Mr. ECKHARDT. What about you, Mr. Birnbaum?

Mr. BIRNBAUM. We are not here testifying or asking for a rescission or repeal of 11(a). I think we are asking for support for the SEC in what we think is a simple approach to a problem. Our board has not authorized anyone at this table from AMEX to ask for repeal of or rescission of 11(a) in toto. I think, historically, AMEX, in both letters to Congress and testimony to the SEC since the passage of the Securities Act of 1973, has raised some questions about it, but I don't think we are here today talking about repeal or rescission.

Mr. ECKHARDT. We are here really in two capacities; one is to consider the specific bill the SEC has proposed. Of course, you are here to testify on that, that is your concern, but we also have a broader duty and that is a general question of oversight of the SEC, and I think we would simply be kidding ourselves if we did not recognize that an 18-month delay looks into some questions that are beyond the mere implementation of 11(a). I don't mean by that that it is necessarily envisaged that 11(a) would go out altogether, but it might well be that in the making of rules, that the Commission would want some legislative authority beyond that which they have now, perhaps some legislative guidance. There would also be the possibility that the Congress would not agree with the rules which are made and would prefer to statutorily mandate a different approach and I think that must be taken into account when one looks at the time table. The last panel had indicated that if the only thing that was needed is an implementation of 11(a) rules, why not 90 days? I think the answer to that is that it is twofold. One, the implementation might envision certain legislative changes, and two, we might want to reserve an opportunity to review those rules and have time to act in our own way with respect to controlling the securities market or guiding it, however you want to put it. And if, for instance, the extension was, say, 90 days, we simply would not be able at all to engage in the problem until the next session of Congress. Even a year would put us in the same type of bind again next year as we are in now to get legislation through but the 18 months would give sufficient time for legislative action, so if we act on the basis of the 18-month period, that does not necessarily mean that we simply want to establish the means of eliminating 11(a). It means that practically speaking, we need that amount of time to accomplish the objectives or implementation that I have suggested. I had asked you, though, your general views on this because I think we will have to be considering those as we consider the whole question of the securities industry.

Now, Mr. Hunter you said quite positively, that 11(a) should be continued, but that time should be permitted for implementation of 11(a). Your organization, I think, may have had somewhat different concerns when this question first came up than it may have

now, because, at that time, there was considerable concern about institutional investors entering in, becoming members of exchanges, and there was considerable pressure for them to do so because of fixed rates. Now that negotiated rates have been put into effect, it seems there is much less threat of institutions, No. 1; being economically impelled to a membership on the exchange, and No. 2, therefore obtaining the kind of dominance that your members might have seen as a threat.

Section 11(a) has another edge which your members, apparently, are feeling now—you are coming in to suggest an extension of time—and that is that it restricts your members when they are engaged in both money management and brokerage. Is there any rethinking of your organization's position with respect to 11(a) on more basic grounds than the mere question of an extension?

Mr. HUNTER. We are frequently accused of vacillating over the years on our position on 11(a), and I think our vacillation is a product of responses to what we read in Washington in terms of their feeling on 11(a). Our basic postures on 11(a) have not changed. To review them very succinctly, we think 11(a) achieves something worthwhile for the nation. Section 11(a) deals with the public nature of the market. If, in fact, the philosophical underpinning of Congress, when it passed 11(a) was a belief in the public nature of the market, then 11(a) is an attempt to maintain that public nature.

My feeling is that allowing large institutions to become members to do their business result in a market, whether it is a national market system or the current system, which is dominated by institutions. They are already 75 percent of the New York Exchange Market. We happen to believe in the public nature of the markets. That is what the broker network across the country has provided over the years. I think that is threatened now. That has been our position.

The second facet of it, which is perhaps the other edge that you speak of, is that we think Congress had in mind the creation of a system in which competition was fair, equal and vigorous and as we review the history, I would concede that in the views of many people, perhaps myself included, under the old fixed rate system, we did have a competitive advantage. What changed? Everyone who has come here has conceded that institutions have economic access to the exchange markets. As a matter of fact, most of us would concede, or certainly firms like my own would concede, they probably have better access than we have, so where is our competitive advantage. As perceived by what we believe the SEC and the Congress understood when we all worked on this 3- or 4-years ago, the competitive advantage that we had had to do with execution on the floor, and therefore, the phrasing in terms of the word effect. In our minds, the understanding that was reached was that we would give up that last remaining competitive advantage, and then we would have a system in which we all compete equitably, if not identically. In fact, I think that is what we have in this phrase that I first heard from Mr. Pollack of the SEC last summer when he talked about the delicate balance of competition, and in fact the SEC, in the third rule that it proposed last March, precisely stated that principle. In our minds, the basic issues under 11(a) that we deal

with, if you put it in the longer term or philosophical sense, are—what types of markets do you want in this country? Do you want broad public markets or do you want institutional markets? And secondly, what type of competition do you want—and the competition that we think is fair and equal to all, and where there is no obvious imbalance that we can see, is the competition which would be maintained by our interpretation of 11(a).

Part of the reason that we want to delay is that we think we can convince the SEC, difficult as that is, that this was the basic approach of Congress when they passed this.

That is our underlying feeling.

Mr. ECKHARDT. But some of the brokers engaged in certain types of activities in which money management and brokerage is combined contend that relatively small accounts cannot be profitably handled unless that mixture exists and they would have to substantially change their nature of operation if 11(a) went into effect. I think Mr. Casey mentioned that to take care of that and to still put into effect 11(a) would require exempting certain accounts below a certain level. What is your reaction to that? In the first place, is the contention a valid one, and a practical one, and in the second place, is the suggestion desirable or not desirable?

Mr. HUNTER. I would say that I believe there are ways in which the SEC can interpret 11(a). They have the ultimate authority, or Congress, or together, and 11(a) as it is read, as it is written could be interpreted by either the SEC or Congress in such a fashion as to eliminate the brokerage business which, at this point in time, wouldn't be the most serious economic effect on the Nation. On the other hand, I think there is interpretation of 11(a) which is entirely reasonable and consistent with the two basic things I mentioned—the long term public nature of the securities markets and the free and equal competition. That competition isn't identical in all respects. Certainly, money managers are today attracting accounts on the basis that they can do the business for their clients, cheaper than brokers, or that they can also furnish other services. So the competition is not identical, but it is pretty darn keen and pretty darn clear.

In terms of managing accounts, we have only one competitive edge—we are a little better at it than most of the institutions. We have a little less credibility because of the historical nature of our products, which are risk products, and we are not in a world of great risk-taking at the moment. I am not sure I answered your question very well.

Mr. ECKHARDT. Well, you hit all around it.

Mr. HUNTER. If you will make your question shorter, I will make my answer shorter.

Mr. ECKHARDT. Mr. Martin, in the prenegotiated rate environment where, presumably, margins on institutional business are very small, if they exist at all, what is the benefit of broker dealers in being able to execute for accounts they manage?

Mr. MARTIN. If the margins of the commission is so small?

Mr. ECKHARDT. Yes.

Mr. MARTIN. Well, you want to control the account and you want the fee business that is also involved.

Mr. ECKHARDT. Do you have any questions, Mr. Oppen?

Mr. OPPEN. With respect to the priority rule and its effect on the two exchanges, the New York Stock Exchange is not with us here today. I was wondering if you gentlemen could comment whether the same adverse effect that you perceive would concern the New York Stock Exchange?

Mr. BIRNBAUM. I think it is probably identical to the AMEX experience and very similar to Mr. Sullivan's, with some technical differences, but I would feel relatively certain New York is experiencing the same problems we are with that and will experience them in the future.

Mr. ECKHARDT. Ms. Nord.

Ms. NORD. Witnesses yesterday testified that we are talking about only 3 percent of the business. Do you have any comments on that?

Mr. HUNTER. If it was 3 percent a year ago, it is less. In trying to plan in our business it is an extremely difficult process simply because of the rapid change in the business. Just take a few basic economics of our business.

In our association, there are 466 firms left; 5 years ago that was 853. So the industry, in terms of number of firms, is down that much.

Secondly upwards of 70 percent in value of public business on the exchange is done by institutions. The industry does some of that business at a loss. There are still firms that make money in that business, a few, but a substantial proportion is a loss business for our industry. The return on capital in our business is such that we can't readily attract new capital. The after tax return on equity capital last year, as best I can determine, is between 6 and 7 percent, and the only reason it was that high is because we moved out of the equity securities business. Our firm wouldn't be alive today if we were in the same business we were in 5 years ago. We have to shift businesses. We happen to deal with the public on the basic belief that in the long term, if we do this well, the public will pay us for our services, and we will live. That may be an erroneous assumption, but it is at least our plan. This whole world is changing so fast and so dramatically that, yes, I have concerns as to the future of the industry, and as part of my feeling on the public nature of the market, if we really want to have a system in this country where you have 15 institutions and maybe the 3 remaining brokerage firms essentially doing all of the business in the country, we are getting there.

Mr. ECKHARDT. On that optimistic note, we will conclude the hearing.

[Whereupon, at 12:20 p.m., the subcommittee adjourned.]



