The Structure of the Securities Market–Past and Future

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THE STRUCTURE OF THE SECURITIES MARKET—PAST AND FUTURE

THOMAS A. RUSSO AND WILLIAM K. S. WANG*

I. INTRODUCTION

The securities industry today faces numerous changes that may dramatically alter its methods of doing business. The traditional dominance of the New York Stock Exchange has been challenged by new markets and new market systems, and to some extent by the determination of Congress and the SEC to make the securities industry more efficient and more responsive to the needs of the general public. The critical issues facing the industry concern the fixed commission rate, institutional membership, non-member access and the utilization of automated reporting systems. This article will consider each of these issues and its relationship to the others. It is a basic premise of this article that no one of these issues can be studied or solved apart from the others.

Traditionally there has been a sharp distinction between customers and members of the stock exchange. The customers would give buy and sell orders to member firms and would pay a fixed minimum commission rate for a package of services which included research, custodial service, "hand-holding," and execution and clearance of orders. The member firms would either use their own floor-brokers for actual execution of an order on the exchange floor or would purchase the services of an independent floor-broker at the relatively low intra-member rate for floor brokerage.

When investors were small and weak, it was possible to maintain the differential between a high public commission rate and a low intra-member rate for floor brokerage. But the business climate began to change as institutions came to dominate securities trading. Not only did institu-

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tions have more bargaining power, but also many were broker-dealers themselves or had broker-dealer subsidiaries. The distinction between customer and exchange member was slowly eroded.

The last decade has witnessed a significant increase in the proportion of securities trading by institutions. The growth in institutional share volume has been accompanied by a large increase in the average size of institutional orders. This growth in institutional trading has greatly increased the profitability of the brokerage industry, especially among those firms specializing in institutional business. Higher profit margins for such firms resulted from a commission rate schedule which simply did not recognize the economics of handling large orders. For example, until recently, the average cost of handling a 1,000-share, a 10,000-share, and a 100,000-share order of a $40 stock was respectively about 6, 42, and 377 times greater than the average cost of handling a 100-share order. Yet the commission that could be charged was, respectively, 10, 100, and 1,000 times the 100-share commission.

Since institutions were large and sophisticated customers, there was vigorous competition among brokerage firms for their business. Not surprisingly, the minimum commission structure began to erode. This erosion did not take the form of an outright rebate to the customer, since such rebates were prohibited by the constitution of the New York Stock Exchange. Instead, a brokerage firm eager to attract institutional customers would charge the full commission for the execution of an order, and then redistribute part of the commission to another broker designated by the institutional customer. Such redistributions were called "give-ups" and were of two types. In the case of give-ups by check, the

3. Between 1960 and 1969, on the New York Stock Exchange alone, the estimated share volume of institutional investors rose from about 360 million shares, or 28 percent of the 1960 total public volume, to almost 2.3 billion shares, more than 50 percent of the 1969 public volume. The two largest groups of institutional investors, banks and mutual funds, increased their share of total public volume from 18.3 to 34 percent during this same period. Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2167-68 (1971) [hereinafter cited as Institutional Investor Study].

4. Id. at 1537-42.

5. The constitutions of the various stock exchanges fix minimum commissions which member firms must charge customers for executing security transactions.


7. "[Commissions] shall be net and free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement direct or Indirect." NYSE Const. art. XV, § 1, CCH NYSE Guide ¶ 1701 (1972).

recipient broker-dealer would perform no part in the execution and
clearance of the trade in question but would still receive a portion of the
commission. In the case of a floor give-up, the executing broker would
execute but not confirm the execution. Instead, another broker would be
asked to confirm the transaction, and would receive a clearance commis-
sion, fixed by the stock exchange, far in excess of the actual cost of con-
firming the order. The fierce competition for institutional business
resulted in give-ups of as much as seventy percent of the NYSE minimum
commissions by the executing broker.

The SEC was opposed to give-ups for several reasons, one of which
was that these rebates were used by mutual funds mostly to reward those
who pushed fund sales. Rarely was the rebate used to obtain lower
commission rates or to cut down expenses for the benefit of fund share-
holders. In 1968, under pressure from the SEC, the New York Stock
Exchange prohibited customer directed give-ups by adding the following
sentence to its constitution:

No member, member firm or member corporation shall, in consideration of the receipt
of listed business and at the direct or indirect request of a non-member or by direct
or indirect arrangement with a non-member, make any payment or give up any work
or give up all or any part of any commission or other property to which such member,
member firm or member corporation is or will be entitled.

The NYSE constitution was further amended to adopt a volume discount
in commissions. The American Stock Exchange and all the regional
stock exchanges also adopted a give-up prohibition and a similar
volume discount. Even after the volume discount, however, the rates
on large orders remained far above the actual cost of execution.

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10. Id. at 2184; Securities Industry Study, supra note 1, at 117-18. Although the New
York Stock Exchange did not permit give-ups to non-members (NYSE Const. art. XV,
§ 8, CCH NYSE Guide $ 1703 (1972)), some of the regional exchanges allowed give-ups
to any member of the National Association of Securities Dealers (NASD), including mutual
fund advisors and mutual fund underwriting subsidiaries. Other regional exchanges only
permitted give-ups between members, but allowed institutions to become members.

11. "While it is the mutual funds themselves whose portfolio transactions provide the
brokerage which constitutes the currency of reciprocity, its principal beneficiaries are not
the funds but their investment advisers and principal underwriters." SEC, Special Study
[hereinafter cited as SEC Special Study].

12. See Securities Industry Study, supra note 1, at 132 & n.14; Note, Conflict of Interest

13. NYSE Const. art. XV, § 1, CCH NYSE Guide $ 1701 (1972).
15. Institutional Investor Study, supra note 3, at 2200. See also Note, Informal Bargaining
Process: An Analysis of the Securities and Exchange Commission's Regulation of the New
York Stock Exchange, 80 Yale L.J. 811 (1971).
Although give-ups by check had been eliminated, floor give-ups continued. Furthermore, the nature of large-block trading had changed so that the minimum commission rate on many extremely large transactions had become meaningless. Block trades are often too large to be brought to the floor of an exchange without a prior assembling of orders on the other side of the transaction. The major brokerage firms which cater to institutions have block trade assemblers who telephone customers, contact other brokerage houses, and possibly confer with the exchange specialist until the other side of the order is assembled. Frequently, it is impossible to assemble sufficient orders to cover the entire transaction. In such instances, the brokerage firm may "position" part of the block by temporarily taking it into its own account.\(^{16}\)

Block trade assemblers suffer average trading losses per block trade of about one-half of one percent of the amount positioned (excluding commission equivalents).\(^{17}\) Block positioning firms are willing to average a loss on this activity in order to earn commissions on the rest of the trade. On any block trade in which some or all of the block is positioned, therefore, there is in fact no minimum commission rate. The brokerage firm makes an estimate of how much it expects to make on the entire deal, including a probable trade loss, and then decides at what price it is willing to purchase part or all of the block for its own account.

Moreover, institutional investors seeking to reduce commission costs have been forming subsidiaries or affiliates to join regional stock exchanges.\(^{18}\) There, the subsidiary or affiliate can either directly execute the institution's transactions, or save commissions through complex reciprocal practices with other member firms.\(^{19}\)

The fixed commission system of the NYSE faces a challenge from another front. Securities listed on the NYSE are also traded on the "third market",\(^{20}\) where dealers attempt to purchase and sell shares at better net prices than those available through members of the Exchange. Member firms, however, are in effect prohibited from taking advantage of third market prices by the rules of the Exchange.\(^{21}\)

\(^{16}\) In addition to "positioning" part of a block which cannot immediately be unloaded, block positioners frequently make bids or offers for the entire block early in the assembly process. They will then attempt to unload the shares or cover their short position as quickly as possible, although the process often takes several weeks.

\(^{17}\) Institutional Investor Study, supra note 3, at 1613-14.

\(^{18}\) See Securities Industry Study, supra note 1, at 118.

\(^{19}\) See Institutional Investor Study, supra note 3, at 2185-88; text accompanying notes 62-71 infra.

\(^{20}\) That is, the over-the-counter market made by broker-dealers who are not members of the NYSE.

\(^{21}\) See NYSE Rule 394, CCH NYSE Guide ¶ 2394 (1972); text accompanying notes 75-94 infra.
The advent of automated trading systems is another phenomenon likely to revolutionize the structure of the securities industry.\(^\text{22}\) The NYSE's barriers to a fully competitive securities market are clearly inconsistent with central quotation systems which would permit investors to determine immediately where they could obtain the best net price.

Still another development which is changing the environment of the brokerage community is the new awareness that the Stock Exchange is not immune from antitrust laws. In the landmark case of *Silver v. New York Stock Exchange*,\(^\text{23}\) the Supreme Court held that the test for resolving conflicts between antitrust and regulatory statutes is the necessity of the antitrust exemption. The Court noted that antitrust law “[r]epel is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary.”\(^\text{24}\)

Since *Silver*, the Justice Department has hinted that it might challenge the legality of fixed minimum commission rates, limitations on membership, and certain other NYSE rules which restrict competition. The threat of such action has precipitated SEC proposals, and NYSE acceptance, of changes in the operation of the market.

The balance of this article will discuss the interrelated problems of New York Stock Exchange antitrust immunity and the increased institutionalization of securities trading which has resulted in the erosion of the distinction between customer and exchange member.

II. Access

Until recently a broker-dealer who was not a member of the New York Stock Exchange was required to pay the full non-member rate if he transmitted an order to a member firm for execution on the Exchange. If a non-member broker-dealer received an order from a customer to purchase 100 shares of a company listed on the New York Stock Exchange, and the broker-dealer transmitted this order to a correspondent

\(^{22}\) See text accompanying notes 142-59 infra.  


\(^{24}\) Id. at 357. See generally Securities Industry Study, supra note 1, at 155-68. On August 5, 1971, Mr. William McChesney Martin, Jr., former chairman of the Federal Reserve Board, submitted to the Board of Governors of the NYSE his report on the securities market. The “Martin Report” argued for exemptions for the Exchange from the antitrust laws: “The scope of the immunity granted to the exchange should be co-existent with the scope of the Securities and Exchange Commission’s control of the exchanges under the Exchange Act, so that no action or omission by a registered national securities exchange in performing any of its duties of self-regulation under the Exchange Act which are subject to review by the Securities and Exchange Commission could give rise to any claim under the anti-trust laws.” [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,184, at 80,564 (Aug. 5, 1971) [hereinafter cited as Martin Report].
member firm in New York, the correspondent in the past charged the
non-member firm the full public commission rate. Since competition
forced the non-member firm to charge his customer the public NYSE
commission rate, the non-member would ostensibly make no profit on
the transaction. In practice, however, the correspondent would generally
realize a profit through the "return" of part of the commission by means
of various reciprocal practices. Nevertheless, there was considerable
pressure on the NYSE from non-members and from the SEC to grant
non-member broker-dealers a preferential rate somewhere between the
intra-member rate and the public commission rate. It seemed difficult to
justify a different rate for different broker-dealers simply because one
had paid the cash to purchase an Exchange seat.

The problems of granting preferential rates (access) to non-member
broker-dealers revolve around the fact that most mutual fund manage-
ment companies are broker-dealers registered with the National Associ-
ation of Securities Dealers26 or have underwriter subsidiaries which are so
registered. Under these circumstances, granting access to non-member
broker-dealers would also mean giving access to a large group of cus-
tomers. Furthermore, instead of asking for the preferential rate for itself,
a mutual fund could route an order through one of its major non-NYSE-
member fund sellers. The fund seller could then send the order to a major
NYSE member firm with a good reputation for executions (a lead broker)
and thereby pocket the difference between the public commission rate and
the preferential access rate. In many respects this arrangement would
be similar to the give-up by check system which was eliminated in 1968.27

On October 3, 1971, the SEC directed that the New York Stock Ex-
change grant 40 percent access to non-member broker-dealers.28 The
Exchange published its interpretation of this mandate in NYSE Circular
No. 344. According to the Exchange, the 40 percent access provision
should benefit only those non-member broker-dealers who carried their
own accounts, and should be provided only for customers' orders.29

The New York Stock Exchange interpretation meant that third market
makers could not receive the benefit of the access provision where they
transacted business for their own account through member firms. The

25. See In the Matter of the SEC Rate Structure Investigation of National Se-
curities Exchanges 5410-14, SEC File No. 4-144 (May 15, 1969) (testimony of William
Freund, Vice-President and Economist of the NYSE). See also Section IV infra.
26. NASD is a self-regulatory association formed by industry members in 1939 to police
the over-the-counter markets. See Securities Industry Study, supra note 1, at 82.
27. See text accompanying notes 7-13 supra.
28. Letter from SEC Chairman Casey to NYSE President Haack, Oct. 3, 1971, in
interpretation further limited the access provision to those non-members who cleared their own accounts. Thus where a non-member had accounts carried by a member or another non-member, the access provision would be inapplicable.

This latter limitation on access was appealed to the Commission by Source Equities, Inc., a small broker-dealer located in New York. Source claimed that the access provision was never intended to apply only where a non-member carried its own accounts. Under pressure from the Commission, the New York Stock Exchange changed its access provision to accommodate non-members who did not clear their own accounts. The effect of this action was an unbundling of the clearance function for certain non-members.

The 40 percent access provision did not directly benefit the public investor in that, under the New York Stock Exchange interpretation, the non-member was not permitted to charge anything less than a full commission to its customer. However, the access provision did permit non-members to have "a piece of the action" with respect to fixed rates without going through various reciprocal practices.

III. INSTITUTIONAL MEMBERSHIP

The most obvious means by which an institution could bypass the high fixed minimum commission rates was to become a member of the New York Stock Exchange. The Philadelphia-Baltimore-Washington

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31. Unbundling is the separate pricing of the variety of services ordinarily covered by a single commission, including clearance, execution, research, etc. See Securities Industry Study, supra note 1, at 145; text accompanying notes 72-74 infra.

32. Several large institutions have expressed interest in purchasing NYSE seats. Investors Diversified Services, which manages the largest complex of mutual funds in the United States, sells its funds through its own captive sales force. Therefore, it does not need give-ups to reward large numbers of independent broker-dealer's fund-sellers. Partly for this reason, and partly out of a sense of duty to the shareholders of its funds, I.D.S. has long expressed interest in becoming a member of the New York Stock Exchange. See SEC Rate Structure Investigation Hearings 2463-539 (July 31, 1968) (testimony of Robert Loeffler et al). In October 1971, Jefferies & Co., a subsidiary of I.D.S., applied for membership on the NYSE. Upon being refused, Jefferies filed suit against the Exchange on antitrust grounds. Jefferies & Co. v. NYSE, Inc., Civil No. 71-4542 (S.D.N.Y., filed Oct. 18, 1971).

In January 1971, the Dreyfus Corporation became the first mutual fund organization to formally apply for membership on the New York Stock Exchange. N.Y. Times, Jun. 14, 1971, at 53, col. 7. In a press conference in March 1971, Donald S. MacNaughton, chairman and chief executive of the Prudential Insurance Company, chided the New York Stock Exchange for moving too slowly in widening its membership to include institutions such as Prudential. N.Y. Times, Mar. 3, 1971, at 57, col. 7.

Coincidentally, on the same date as Mr. MacNaughton's March 1971 press conference,
The Pacific Coast Stock Exchange has also permitted membership to subsidiaries of institutional investors, but has been more restrictive than the PBW. The New York and American Stock Exchanges have not allowed institutions to become members, but many firms which are already members of these exchanges have started their own mutual funds and have diversified extensively into money-management activities. In short, the NYSE presently permits its members to expand into the mutual fund business but does not permit mutual fund management companies to expand into the Exchange broker-dealer business.

There seem to be three specific reasons for affiliations between institutional investors and broker-dealers. The first, and perhaps most obvious, is the benefit of reduced brokerage commission costs to the accounts managed by the institutional investor, often while increasing the income of the institutional investor itself. By joining an exchange, an investment advisor gains the benefit of the intra-member floor brokerage rate. He can then either charge his clients the full public commission and pocket the difference, or pass all or part of the commission savings to clients. Many institutions have joined regional exchanges to save commissions on transactions executed on the regionals and also to receive rebates on NYSE business. When such an institution gives NYSE business to a brokerage firm which is a member of both the regional exchange and the NYSE, the dual-member brokerage firm will often give a floor give-up to the institution on unrelated regional business. Thus, any institution with a regional exchange membership in effect has the benefit of negotiated commission rates on the NYSE.

The second reason is the diversification of the business of the institutional investor in the financial area while supplying additional sources of capital to the broker-dealer. In some instances, a bank, an insurance company or other corporation may require a brokerage firm mainly because it wants a profitable subsidiary. There have been instances where institutions have acquired broker-dealers and these broker-dealers have continued to do a general broker-dealer business with customers other than the acquiring institutional investor.

New York State Controller Arthur Levitt announced that he would seek a New York Stock Exchange seat for the state's $4.5 billion pension fund if the New York Stock Exchange did not alter its fixed commission schedule to include negotiated rates. N.Y. Times, Mar. 3, 1971, at 57, col. 4.

34. Institutional Investor Study, supra note 3, at 2308.
35. Id. at 2296-300.
A third benefit of affiliations between institutional investors and broker-dealers is the investor’s ability to make use of the distribution facilities of an affiliated broker-dealer to sell its services. For example, a mutual fund might wish to acquire a retail brokerage firm in order to obtain a “captive” sales force with which to sell its shares.

Of course, an institution might acquire a mutual fund for all of these reasons. The New York Stock Exchange has been concerned about the possible loss in commission revenue to existing members in the event that institutions were to be allowed to purchase seats and obtain the intra-member commission rate.

On March 26, 1970, after much negotiation with the SEC and discussion among the Exchange members, the NYSE formally adopted rules and amendments which permitted member firms to sell stock to the public.36 In order to prevent institutions from acquiring the stock of a publicly held member firm, the Exchange adopted a constitutional amendment which provided:

The primary purpose of [the member] corporation, and of any parent of such corporation, [must be] the transaction of business as a broker or dealer in securities . . . .37

The Exchange also promulgated a rule explaining the provision. The rule provided, in pertinent part:

A member organization’s, or its parent’s, “primary purpose” shall be presumed to be the transaction of business as a broker or dealer in securities, if its gross income (including, in the case of a member organization, the gross income of its corporate affiliates and subsidiaries controlled by the member organization) from [the transaction of business in securities] and from interest charges imposed with respect to debit balances in customers’ accounts is at least 50% of its total gross income . . . .38

The Exchange argued that this provision was necessary to ensure control by the Exchange and the SEC of any parties who own a member firm.39 The Justice Department filed comments with the SEC opposing the regulations proposed by the NYSE and maintaining that control over persons in management positions was sufficient to achieve necessary regulation.40

On October 12, 1971, the SEC began hearings concerning the market structure of the securities industry. One of the topics which received ex-

37. NYSE Const. art. IX, § 7(b)(5), CCH NYSE Guide ¶ 1407 (1972).
tensive discussion at those hearings was institutional membership. The Commission released its findings at the conclusion of the hearings on February 2, 1972, in a sixty-four page report entitled Statement of the Securities Exchange Commission on the Future Structure of the Securities Market.

The SEC stated in its report “that membership in the central market system should be open only to those who meet qualifying standards and who have the primary purpose of serving the public as brokers or market-makers.” The Commission emphasized its belief that large investors should not, “by virtue of their economic power and size, be entitled to obtain rebates of commissions not available to other investors.” So long as fixed commission rates exist, stated the SEC, they should apply to all investors without exception. “Institutional membership, however,” it pointed out, “provides a vehicle for obtaining rebates, either directly or indirectly.”

The Commission also noted that institutional membership is often acquired for private purposes rather than for the purpose of serving the public in an agency capacity or otherwise performing a useful market function. The Commission was concerned that the only purpose of institutional membership for many institutions was to recapture commissions. The SEC concluded:

The public should have the assurance that a member of an exchange is dedicated to serving the public, and membership by institutions not predominantly serving non-affiliated customers should not be permitted to cloud this objective.

The Commission made it clear, however, that the type of institutional membership it opposed was that of an institution whose affiliate did not have as its primary purpose service to the general public as a broker-

41. Before beginning these public hearings, the SEC requested that all regional exchanges impose a moratorium on new institutional members until the Commission had an opportunity to study the question. Mr. Elkin Weatherill, President of the Philadelphia-Baltimore-Washington Stock Exchange, would not agree to such a moratorium. Mr. Weatherill stated, “We felt we were doing the right thing, so we said we would process the applications we had, but would not solicit new ones.” N.Y. Times, Feb. 20, 1972, § 3, at 2, col. 8.

42. SEC, Statement on the Future Structure of the Securities Markets 44 (Feb. 2, 1972) [hereinafter cited as SEC Statement]. Shortly after the SEC’s pronouncement, Senator Harrison A. Williams, Jr., the Chairman of the Senate Subcommittee on Securities, introduced a bill which would suspend the SEC's power to bar institutional membership. S. 3347, 92d Cong., 2d Sess. (1972). Senator Williams' position is that the “primary interest” test of the SEC is unsound and unfair as long as commission rates remain at artificially high levels. Address by Senator Williams, Mid-Continental Securities Indus. Ass'n, Chicago, Mar. 11, 1972.

43. SEC Statement, supra note 42, at 46-47.

44. Id.

45. Id. at 48.
dealer. In the opinion of the SEC, where an institution had an affiliate which did a vast majority of its business with the public, no major problems were presented.\textsuperscript{46} Under the SEC's theory of institutional membership, an affiliated broker-dealer which did 100 percent of its business for its affiliated institution could merge with another broker-dealer and would be permitted to remain a member so long as the predominant portion of its business after the merger was "public" in nature.

The primary argument of the Commission was that often institutional membership is used to rebate commissions, thereby making the fixed commission rate a negotiated rate. The Commission apparently felt that if small investors must pay a fixed commission, there was no reason why large investors, because of their economic power, should pay anything less. Of course, the Commission had another approach open to it which would have solved this problem. It could have required negotiated rates for all. As long as there is a fixed commission rate and as long as broker-dealers are willing to accept something less than the fixed rate, history has shown that methods will be devised by which institutions are able to recapture commissions. The heart of the problem is not institutional membership, but the fixed rate.

The Commission's second argument against the membership of institutions whose primary purpose is not to do public business was based upon the belief that such memberships are obtained only for "private" purposes, and provide no "useful service to the investing public."\textsuperscript{47} However, to the extent that the beneficiaries of institutional membership are the participants' investment companies, pension funds, and the like, it seems difficult to argue that the nature of their business is purely "private."\textsuperscript{48}

It is interesting that the SEC in its February 1972 Statement did not mention the argument that to permit institutional members would open the door to "the concentration of economic power."\textsuperscript{49} Perhaps the reason for this omission was the SEC's realization that its "primary purpose" test could encourage institutions to expand to include "public" brokerage business. The SEC's position could lead to economic concentration in the securities market.\textsuperscript{50} The fact that the Commission disregarded the

\textsuperscript{46} Commissioner Owens dissented on this point. He noted: "I further believe, however, and it is here that I disagree with my colleagues, that such affiliated broker-dealer should be required to do exclusively a public business and should be prohibited from engaging in any securities transactions with its parent or affiliate." Id. at 61.

\textsuperscript{47} See Address by SEC Chairman Casey, New York Economic Club, Mar. 8, 1972.


\textsuperscript{49} See Martin Report, supra note 24, at 80,562.

\textsuperscript{50} For an excellent discussion of the flaws of the "primary purpose" test, see the state-
New York Stock Exchange's argument that exchanges cannot regulate a parent or affiliate institution may indicate that the Commission concluded that such control was possible. Thus, a key argument of the NYSE in favor of its "parent" test was answered by implication.

On May 26, 1972, the SEC formally requested that the stock exchanges adopt rules which would permit membership for brokerage affiliates that did at least 80 percent of their securities business other than for an affiliated institution. The 80 percent test would exclude from membership organizations whose primary function was to recapture or rebate commissions, or to execute transactions for affiliated persons or organizations.

The House Subcommittee on Commerce and Finance, in its August 23, 1972 Securities Industry Study Report went even further than the SEC on the issue of membership for broker-dealers affiliated with institutions. The Subcommittee recommended that "[c]apital and competency should be the exclusive criteria for determining eligibility for exchange membership." However, it further recommended "[t]hat there should be a statutory prohibition against any broker-dealer engaging in brokerage transactions for its affiliated accounts . . . ."

The Subcommittee's proposal would open membership to any otherwise qualified institutionally affiliated broker-dealer, but would preclude them from handling any brokerage business for the institution. According to the Subcommittee, current exchange members would be subject to the same restrictions.

The SEC's 80 percent test was specifically rejected by the Subcommittee:

While at first blush this proposal appears to be a step along the path to the Subcommittee's recommendation of a flat prohibition, on closer analysis it appears that the Commission's proposal will cause more harm than good.

The Subcommittee said that it agreed with the Justice Department's belief that the proposed percentage test would result in an undesirable wave of mergers between institutional investors and leading brokerage

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51. See note 37 supra and accompanying text.
52. See Letter from SEC Chairman Casey to the New York Stock Exchange, May 26, 1972. The SEC gave the exchanges until July 31 to formulate their plans. On July 28, the SEC said that it was apparent the exchanges would not meet the deadline, and announced that it would shortly convene an appropriate regulatory proceeding. SEC Securities Exchange Act Release No. 9623 (May 30, 1972).
54. Id. (emphasis added).
55. Id.
56. Id. at 151.
firms that are already exchange members. The Subcommittee also pointed out that the 80-20 test could have an adverse impact on regional brokerage firms, because it would force institutionally-affiliated broker-dealers to try to attract the customers of regional firms in order to meet their non-affiliated brokerage test. The "devilish" bookkeeping problems, and the unwarranted turn-over in customers' accounts which could result from a firm's need to increase its non-affiliated business were two more reasons for the Subcommittee's opposition to the SEC's percentage test.

The institutional membership controversy raises the question whether there is an inherent conflict of interest between money management and the brokerage business. Will a brokerage firm owned by an institution favor the institution over its public clients? Will it use its "customers' men" to push securities which the institutional parent is selling or has already bought? The Exchange is somewhat reluctant to raise this question, since its members already are heavily involved in money management, and some conflict of interest presently exists.

The adoption of negotiated commission rates for transactions above $300,000 will ease the pressure for institutional membership, but the problem will remain until negotiated rates are instituted for all large trades. If fixed minimum commission rates were abolished entirely, there would be so little difference between a member and a non-member that non-member institutions would have much less incentive to join and member firms would have little incentive to keep institutions out.

IV. RECIPROCAL PRACTICES

Economic back-scratching seems to be a way of life for American business. The securities industry is clearly no exception. Because the fixed public commission rate is excessive, brokerage firms compete for business by doing favors for their customers. One important favor is reciprocal business.

In the past, a regional-only member had to pay the full public NYSE commission rate when it executed an order on the Exchange. It would

57. Id. at 151-52.
58. Id. at 152.
59. Id. The Subcommittee expressed an awareness that "sweetheart deals" could result from both its own proposal and that of the SEC. That is, "two or more broker-dealers may work out arrangements wherein each agrees to channel to another the brokerage business of its affiliated accounts if similar business is directed in return." Id. at 152-53. The Subcommittee could offer no solution for this problem, other than rigorous enforcement by the SEC.
60. See id. at 148-49.
61. See text accompanying notes 133-40 infra.
appear that the non-member firm would thus make no profit on a trade executed for the customer. In fact this was not the case. The regional-only member would send all its NYSE executions to a dual-member correspondent, which would keep track of the commissions it received from the regional-only firm and return a prearranged percentage of the commissions through floor give-ups on unrelated business on the regional exchange. In other words, if R. Co. was a member of the Philadelphia-Baltimore-Washington Stock Exchange but not a member of the New York Stock Exchange, it could still make a profit on NYSE business. When it executed an order for a customer on the NYSE it would send the order to D. Co., a member of both the NYSE and the PBW. Although R. Co. would pay D. Co. the full public commission rate, D. Co. would name R. Co. as its clearance agent on some unrelated trades that it was executing on the PBW Exchange, thereby returning part of the NYSE commission in the form of PBW clearance commissions. The percentage of the rebate would be subject to negotiation but would generally be about 50 percent. In short, non-NYSE members, even before the adoption of the 40 percent access provision, received access if they were members of the regional exchanges. Today, any institutional investor-broker-dealer which is a member of a regional exchange can, in effect, enjoy negotiated commission rates on all NYSE business.

There are other forms of reciprocity between institutional investors and brokerage firms. SEC’s Institutional Investor Study reported that seven out of forty-six banks studied paid almost 98 percent of their free commissions to depositors. Often, banks would allocate a specific number of commission dollars to a brokerage firm for each dollar on deposit. Commission payments tended to be between 7 and 10 percent of the collected balances of each broker-dealer. In the summer of 1970 the Antitrust Division of the Justice Department announced that such reciprocal practices violated the antitrust laws, and the banks appear to have discontinued their more blatant reciprocal procedures.

This article has already described the use of give-ups to reward broker-dealers for pushing mutual fund shares. If a mutual fund distributor is

62. E. Rotberg, Competition and the Securities Market 28 (April 20, 1967). In a speech before the National Investor Trade Conference, Mr. Rotberg brought the house down with the following joke: “Someone reminded me that when [the President of the Pacific Coast Stock Exchange] was in Washington on George Washington’s birthday, he celebrated by throwing a dollar across the Potomac. I am told that somebody threw a half-dollar back.”

63. See text accompanying notes 25-31 supra.


66. See text accompanying notes 8-15 supra.
a member of an organized exchange, especially the New York Stock Exchange, regular commission dollars can be used to reward a broker-dealer for selling the fund’s shares. After the prohibition of give-ups, NYSE member firms had an advantage over non-members in ability to receive extra compensation from mutual fund managers; and NYSE members increased their percentage of mutual fund sales after give-ups were prohibited.

In its February 2, 1972 *Statement on the Future of the Securities Market*, the SEC stated that the use of brokerage fees to reward broker-dealers for selling fund shares must be terminated:

To accomplish this the Commission is sending a letter to the NASD setting forth the Commission’s views and requesting the NASD to direct its members to discontinue the use of reciprocal portfolio brokerage for the sale of investment company shares.

There are serious problems of interpretation raised by the Commission’s statement on reciprocity. For example, would it violate the Commission’s mandate if a mutual fund were to give a substantial amount of its business to a broker-dealer which sells that fund’s shares but is also an excellent broker in the block market?

In one sense, even the allocation of commission dollars in return for research can be viewed as a reciprocal practice. However, research has traditionally been viewed as a legitimate portion of the package of services purchased with the commission dollar. The Commission further observed that under the doctrine of “suitability,” payment for research out of commission dollars was proper. The Commission stated:

It is, therefore, the Commission’s premise that broad-based securities research and its prompt and fair dissemination to large and small investors is indispensible to an efficient system of securities markets. Vigorous enforcement of the standards of suitability discussed above would thus mean that as competitive commission rates are introduced the basic execution charge which would evolve would include the provision of research services to the extent necessary to comply with these standards.

67. See note 13 supra and accompanying text.

68. *Institutional Investor Study*, supra note 3, at 2283-85. The SEC noted that reciprocity between insurance companies and broker-dealers was casual and not effected on any systematic basis. The SEC warned, however, that two recent developments could increase broker-dealer insurance company reciprocity: the acquisition or founding of mutual funds by insurers and the sale of insurance by broker-dealers. Id. at 2285-86.

69. SEC Statement, supra note 42, at 35, 39.

70. Under the Rules of Fair Practice of the NASD (art. III § 2) and the NYSE (Rule 405), broker-dealers have a minimum duty to perform in executing transactions. Failure to conform to “suitability” requirements could mean disciplinary action against the broker-dealer.

71. SEC Statement, supra note 42, at 35, 39.
V. UNBUNDLING

On December 31, 1969 the SEC issued a release which invited comment on a number of questions, the first of which was the following:

Assuming continuation of some prescribed commission rate for such relatively standardized services as "execution" and "clearance", what additional services if any should be compensated by a fixed minimum rate? 72

The response of the Justice Department was not surprising:

This and succeeding questions seem to assume that a fixed rate for execution and clearance alone might be an appropriate solution to the commission rate question. While the evidence submitted has not established the need for having even this rate fixed, such a solution would be preferable to the existing arrangement from the standpoint of economic policy. It seems probable that costs for execution and clearance are more standardized than other costs presently included in the fixed rate . . . .

The disadvantage of such a solution is that it would sacrifice any cost-reducing spur of competition in the execution and clearance process. However, if "execution" and "clearance" costs were confined solely to the expense of operating the joint facilities of the exchange and its clearing house, then there would be little (if any) such adverse affect. 73

The response of the New York Stock Exchange was just as predictable:

Any commission schedule with prescribed rates for only a part of the service components of a complete trade, with the remainder subject to negotiation, would be tantamount to negotiated rather than minimum rates. The ability to negotiate part of the cost of a trade is the ability to negotiate the entire cost. Negotiated rates would splinter the central market and lead to destructive competition. 74

The Exchange made a number of other points, but these were clearly makeweight contentions subservient to the NYSE's major argument against negotiated commission rates. These arguments will be discussed in greater detail in the later section of this article dealing with fixed versus negotiated commission rates.

VI. RULE 394

Securities Exchange Act Release 8791 contained another extremely important question relating to restrictions on NYSE members' off-board trading:


Reference is made to Section 19(b) of the Securities Exchange Act which contemplates that exchange rules should be "for the protection of investors," to "insure fair dealing in securities traded in upon such exchange" and to "insure fair administration of such exchange." Are these standards consistent with exchange imposition of constraints upon the exercise of the judgment of a member, acting as agent, in determining whether it may be in his customer's interest to execute a transaction otherwise than on the floor of the exchange?²⁵

This question refers to NYSE Rule 394(a) which provides: "Except as otherwise specifically exempted by the Exchange, members and member organizations must obtain the permission of the Exchange before effecting a transaction in a listed stock off the Exchange, either as principal or agent." On October 20, 1966, under pressure from the SEC, the NYSE adopted Rule 394(b) which provided for an exemption if and when a member firm showed that it had made "a diligent effort to explore the feasibility of obtaining satisfactory execution of the order on the floor," and filed certain detailed information with the floor governor. Rule 394(b) has received little use, primarily because of the inconvenience and delay caused by the complexity of its prescribed procedures. During the SEC Rate Structure Investigation Hearings, Mr. Morris A. Schapiro testified that, although his firm was the leading non-NYSE firm which made a market in bank stocks, he had had only one transaction with a member firm under Rule 394(b) in 1967 and none in 1968.²⁶

Rule 394 is basically an extension of Article XIV, Section 8 of the NYSE Constitution, which prohibits a member firm from dealing in public orders off the Exchange. In 1941, the SEC, in the Multiple Trading Case, ordered the NYSE to desist from enforcing this policy against the regional exchanges.²⁷ Thereafter any security listed on the NYSE could also be traded by Exchange members on any regional exchange. Anomalously, the SEC still permits the NYSE to restrict its members from trading listed securities off any organized exchange.

The over-the-counter market for NYSE securities is called the third market, a term coined by the SEC in its 1963 Special Study of the Se-

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²⁵ SEC Securities Exchange Act Release No. 8791, at 3 (Dec. 31, 1969). Part (b) of the question continued: "Is it consistent with the above language of Section 19(b) or with the purpose of the 1936 amendments to the Exchange Act—to create a fair field of competition among exchanges and between exchanges as a group and the over-the-counter markets to allow each type of market to develop in accordance with its natural genius and consistently with the public interest—to permit the exchanges to require their members in the handling of agency transactions to give preference (i) to that exchange; or (ii) to exchange markets generally over non-exchange markets?" Id.

²⁶ SEC Rate Structure Investigation Hearings 3988-89 (Nov. 7, 1968) (testimony of Morris A. Schapiro). See also Securities Industry Study, supra note 1, at 126.

²⁷ The Rules of the NYSE, 10 S.E.C. 270 (1941).
Notwithstanding Rule 394, the third market is thriving. In recent years, well-capitalized third market block-traders have been in active competition with NYSE member block-traders, who are required to formally execute their orders on the floor of an organized exchange and to charge the set minimum commission rates.

The Justice Department and such third-market firms as M. A. Shapiro & Company and Weeden & Company have argued that the Multiple Trading Case should be extended to the third market. In that decision, the SEC noted that the reports of the Senate Committee on Banking and Currency and of the House Commerce Committee accompanying the amendments to Section 12(f) of the Exchange Act expressly state that the amendments represent an endeavor by Congress to:

create a fair field of competition among exchanges and between exchanges as a group and over-the-counter markets and to allow each type of market to develop in accordance with its natural genius and consistently with the public interest.

Rule 394 appears to limit the ability of the NYSE member firm to obtain the best execution for his client. In 1936, in Edison Electric Illuminating Co., the SEC stated:

[A] well-governed exchange recognizes limits to its operations as an automatic auction market. . . . [It] should . . . recognize and enforce the duty of a broker to get the best price for his client, even though that price is only obtainable off the floor of the exchange . . .

The Justice Department has commented, "NYSE's Rule 394 represents part of a broader pattern to protect its minimum commission structure by prohibiting NYSE members from dealing in listed securities off the Exchange floor . . . ." The third market poses a special threat to the NYSE, because unlike the regionals, the over-the-counter market has no fixed minimum commission rates. Indeed, such price fixing is expressly prohibited by the Maloney Act amendments to the Securities Exchange Act of 1934. It is difficult for Exchange members to price-fix when there are active competitors outside the cartel who can undercut the fixed prices.
prices. The third market threat is quite real as automation has greatly increased the efficiency and strength of the over-the-counter markets. Indeed, there is now some question whether, absent Rule 394, an automated third market (with negotiated commission rates) might eventually eclipse the NYSE itself. This extremely important development will be discussed in greater detail in the section on automation.

The NYSE's memorandum in response to Release No. 8791 was not very persuasive. For example, the Exchange asserted:

Some critics of Rule 394 have suggested that because it is the duty of a broker to get the "best execution" for his customer . . . , Rule 394 should be abolished. However, application of the broad statutory yardstick of "protection of investors" should focus not on the interests of a single customer on one side of a single transaction, but on the execution of all orders of all customers—both buyers and sellers—day in and day out . . . .

[O]nce the primary central market is splintered, no investor is assured of a "best execution."  

Notwithstanding the Exchange's defense of a central market place, the fact remains that the market for NYSE listed stocks is already fragmented by trading on the regionals and the third market. Since the SEC has decided to encourage competition between the regionals and the NYSE it would seem logical to also encourage additional competition from the third market. Furthermore, if a dual-member firm is really determined to execute a trade in the third market, he can do so without getting approval from the NYSE. Eugene H. Rotberg described this procedure as follows:

[A] sole member of a regional exchange simply is interpositioned between the dual member and the third market-maker. The sole member asks permission, which is invariably given, to sell (or buy) off-board to a third market maker. The sole member profits by purchasing at a price differential from the dual member in a simultaneous on-board trade. This permits the New York member to avoid sending the order on to the New York Stock Exchange where it often must pay a correspondent the required brokerage and clearance fees. Moreover, on the Pacific Coast Stock Exchange, some third market makers are members of the Exchange. Under these circumstances, New York members can deal with them on a net basis as co-members without even the need for interpositioning a sole member.  

The use of this procedure has been increasing for reasons that will be discussed in this article's section on automation. The availability of this loophole raises the question of whether the entire rule should be rescinded.

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86. NYSE Memorandum, supra note 74, at 43.
88. In his Jan. 26, 1972 statement at the hearings on market structure before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign
In 1965 the SEC staff investigated Rule 394. The results of the study were transmitted to the Exchange, but the SEC refused to release the report to the public. Two and one half years later, Morris A. Schapiro was finally able to extricate the summary and conclusions of the study from the SEC. He promptly published this material in the September 1968 issue of “Bank Stock Quarterly,” a magazine published by his company. The SEC finally released the main body of its staff study on December 14, 1971. The summary made clear the fact that the staff investigators concluded that Rule 394 was undesirable:

The purpose and effect of the [rule] is to inhibit competition of the member firm and non-member dealer with the specialist. . . . [It] reflected a decision by the Exchange that all non-members be required to pay a minimum commission on the execution of any order to which they were a party . . . .

Rule 394 is geared to the economic interests of Exchange members . . . .

The report went on to suggest a system which, it said, could give firms maximum access to all bids without fractionalizing the market:

In our view this can best be accomplished if the New York Stock Exchange were to return to a principle it formerly recognized and which other exchanges observe today: a broker executing an order for a customer is not entitled to a second commission from a party sought out by the broker to fill the other side of the order. In other words, a broker executing an order for a customer by dealing with a non-member market-maker would not be required to charge that dealer a commission. The order should still be brought to the floor (as member crosses now are) so that the beneficial aspects therein involved would be preserved, such as priority of bids and offers, publicity, regulation, and the depth; we believe that the quality of executions would be benefitted and the so-called “third market” would remain as a competitive force in the overall market.

Commerce, Mr. Morris Schapiro explained how Rule 394 works: “There is much talk of Rule 394, but people don’t know what it means to them—in their pocketbooks. The rules are schemed to get two commissions at the expense of the customer—two fixed commissions.

I witnessed a vivid example of this just the other day. One of our traders received a call from a prominent NYSE member firm asking what we would pay for 3,000 shares of a stock listed on the NYSE whose last sale there was 29 3/4. Our trader bid 29 3/4 net for the block. The member firm asked, ‘do you mind lowering your bid to 29 1/2? We would then charge you 1/4, and cross the block at 29 1/2.’ ‘Crossing the block’ means that the broker gets two commissions, one from his customer (the seller) and one from us, the dealer. If Rule 394 did not exist, the broker would get the best execution for its customer by accepting the net price of 29 3/4. From this he would deduct his commission, and obtain a net of 29 1/2 for his customer. But because of Rule 394, the NYSE broker—prohibited from trading on a net basis with a non-member dealer—could only net his customer 29 1/2 since the customer unwittingly must absorb the second commission, a matter of an additional $750 in the broker’s pockets.” Hearing on Market Structure Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 92d Cong., 2d Sess. (1972).

This approach clearly requires change in the minimum commission rate structure of the Exchange.90

The Staff Report considered it the duty of the broker to obtain best execution. It noted that "[t]he basic rule is that a customer who engages a broker to execute an order on an exchange confers authority on the broker to conduct the transaction according to the established rules and customs of the exchange."91 However, if the rule or usage contradicts an expressed agreement between the customer and the broker, is unreasonable, illegal, contrary to public policy or otherwise alters the basic intent of the brokerage relationship, it is not binding upon the customer."92 Thus, the Staff Report seemed to imply that where a NYSE broker knew or should have known that it could receive a better price for its customer elsewhere, Rule 394 could not, without causing a violation of the fiduciary duty of best execution, require the transaction to be executed on the New York Stock Exchange.

In its February 2, 1972 Statement on the Future of the Securities Markets, the SEC considered the creation of a central market system. The Commission stated that in order to achieve a central market system there must be an "elimination of artificial impediments, created by exchange rules or otherwise, to dealing in a best available market."93

The Commission said that all qualified broker-dealers must be able to obtain access to all exchanges. This aspect of the Commission's statement appeared to be aimed directly at the elimination of NYSE Rule 394.

In its Security Industry Study Report, the House Subcommittee on Commerce and Finance also criticized Rule 394, and called for its rescission:

In a central market system whose objectives are that customers should receive the best possible execution of their orders in any market wherever situated and that such orders be transacted at the lowest possible cost, rule 394 has no justification. Accordingly, the New York Stock Exchange should immediately rescind the rule. If this is not done the Subcommittee will introduce legislation which will have the effect of abrogating the rule.94

VII. FIXED VERSUS NEGOTIATED COMMISSION RATES

A. Introduction

On April 1, 1968 the Justice Department surprised both the SEC and the New York Stock Exchange by filing a brief with the Commission95

90. Id. at D-49.
91. Id. at D-21. "[T]he broker's duty to obtain best possible execution for his customer . . . is the very essence of the broker's agency duty." Id. D-19.
92. Id. at D-21 (footnote omitted).
93. SEC Statement, supra note 42, at 10.
94. Securities Industry Study, supra note 1, at 127.
95. Memorandum of the Dep't of Justice, Inquiry into Proposals to Modify the Com-
arguing that fixed commission rates were neither required nor justified by the objectives of the Securities Exchange Act and consequently were a violation of the antitrust laws under Silver v. New York Stock Exchange.66 Stimulated by this pressure, the SEC called for hearings on the commission rate structure.97 In August 1968, the NYSE submitted a reply economic brief to the Justice Department.98 During the next year, the NYSE99 and the Justice Department100 exchanged even longer and more forceful economic briefs on the subject of commission rates.

The debate between the NYSE and the Justice Department continued with the Antitrust Division filing critical comments about Exchange proposals to permit public ownership but prevent institutional membership101 and with replies by both the Justice Department102 and the Exchange103 to SEC Release No. 8791.

B. The Exchange's Arguments

In its economic briefs and testimony, the NYSE made a number of fundamental arguments.

1. The Viability of the Central Auction Market

The first contention of the Exchange was that minimum commissions are necessary as an incentive for brokerage firms to retain membership...
on the NYSE. With the abolition of minimum commission rates, there would be such a leakage of trades that the Exchange would become "an association of floor brokers and specialists." Firms would withdraw as members and conduct the main part of their business by means of crosses in their own offices or in the third market. With splintered markets, the public investor might very well lose on poor executions what he might save on negotiated commissions. The reduced membership on the Exchange would also impair the NYSE's self-regulatory function.

The Exchange's fragmentation argument could be rephrased as follows: Excessive public commission rates give brokerage firms the incentive to join the NYSE both to obtain the lower intra-member rate and to gain the monopolistic profits derived from the high public commissions set by the cartel. Once firms are members of the Exchange, they come under Rule 394 which prevents fragmentation of trading and maintains the liquidity and depth of the central auction market. In short, one of the Exchange's principal arguments in support of the fixed minimum commission rate depends on a belief in the necessity of Rule 394.

Rule 394 can only be justified if it is more efficient to bring all trading in a security to one geographical location. However, the Central Market Place is no longer a geographical concept but a communications concept.104

Even if Rule 394 were justified, however, fixed minimum rates would be a highly inefficient way of inducing brokerage firms to come under its jurisdiction. As Professor Samuelson pointed out in his testimony in the SEC Rate Structure Hearings, the principal barrier to a broker-dealer's becoming a member of the Exchange is the high cost of purchasing a seat, which is due to the artificial scarcity of seats maintained by the NYSE itself. Professor Samuelson urged that all monopolistic restrictions barring access to the facilities of the exchange be made illegal.105

104. "[W]e believe that because of modern communications and data processing facilities it is possible to preserve geographically separate trading markets while at the same time tying them together on a national basis. We are also satisfied that the Commission and other regulatory authorities should endeavor to prevent the evolution of a market place from being distorted by unnecessary restraint on competition." SEC, Letter of Transmittal, Institutional Investors Study, supra note 3, at XXIII. Professor Paul Samuelson has also questioned the premise of Rule 394: "[T]he New York Stock Exchange, as it should operate, is not something which is located on the floor of the Exchange. It is as big as the American T & T telephone network. The securities markets are one live, interconnected whole and the important thing is that there be freedom for equitable and efficient competitive forces to operate throughout that network and not that we protect volume or appearances on one particular domicile of the securities business." SEC Rate Structure Investigation Hearings 3540-41 (Oct. 30, 1968).

105. Id. at 3536-42.
Professor Baumol went even further than Professor Samuelson and commented:

[I]t can also be appropriate to consider making membership on the exchange and adherence to its rules compulsory for any broker-dealer who trades on it more than some specified volume. This procedure as a means to preserve the centralized market and to support self-regulation derives its rationale from the elements of public utility in the function of the exchange which acts as the near-exclusive purveyor of its service (trading in listed securities, particularly in small quantities). 106

Both Professor Samuelson's and Professor Baumol's proposals would increase the number of broker-dealers who were members of the NYSE. Presumably, these new members would tend to trade listed securities on the Exchange both because of Rule 394 and because of the availability of the low intra-member NYSE rate.

A more direct means of increasing the trading of listed securities on the Exchange would be to introduce negotiated rates. It does not take much economic expertise to predict that lower rates would result in more rather than less business for the NYSE. As mentioned earlier, the elimination of fixed commissions would cause the major differences between Exchange members and non-members to disappear. The Exchange would gain back the customers and broker-dealers which presently bring their business to the regionals or the third market in order to grant or obtain rebates and lower commissions.

The NYSE's argument is based on the assumption that if it were desirable to bring all securities trading to a central market place, the NYSE would be that market. This assumption is highly questionable. In 1967 the regional exchanges and the third market together accounted for just over ten percent of all trading in NYSE listed stocks. By 1970, the share of the regionals and the third market had just about doubled, with an estimated 35 to 45 percent of blocks of 10,000 or more shares traded away from the Exchange. 107 The third market is an especially serious threat to the New York Stock Exchange. On February 8, 1971, NASDAQ, the National Association of Securities Dealers Automated Quotations system, commenced operation. Under this system the bid-ask quotations of all participating OTC dealers are continuously inserted into a computer system which instantaneously makes the quotations available on the desk terminals of subscribers to the system. 108 In many respects the system is like a securities exchange with competing specialists.

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106. Id. at 3639.
It might be argued that public policy dictates that the NYSE floor should be abolished and that all trades be brought to NASDAQ rather than vice versa. This question will be discussed in the section of this article on automation, but it is interesting to note that the Exchange’s arguments in favor of one efficient central marketplace may eventually be turned against it.

In summary, the Exchange’s argument that minimum commission rates are necessary to preserve the central auction market fails for several reasons. First of all, the NYSE’s argument depends on a belief in the necessity of Rule 394, and it is not clear that the premise on which Rule 394 is based is correct. Secondly, even if Rule 394 were justified, fixed minimum rates do not appear to be the most efficient or desirable means of inducing broker-dealers to join the NYSE. Giving out seats free or even requiring most broker-dealers to join the Exchange would be much more effective. Furthermore, the ultimate goal of Rule 394 is to increase trading on the NYSE, and negotiated rates would result in more trading for the NYSE, not less. Thirdly, even if it is desirable to bring all trades in a given security to one “exchange,” the NYSE is probably not the place to which the orders should be brought. Even if it were decided that all trades in listed securities should be brought to the NYSE, and that the NYSE were a natural monopoly, it might be necessary to regulate the Exchange itself as a public utility, and the utility commission would set the fees which the Exchange would charge for the use of its services; but broker-dealers using the Exchange facilities would still charge competitively determined commissions for their services to the general public.109

2. Destructive Competition

Although the phrase “destructive competition” is frequently incanted to justify price-fixing, the New York Stock Exchange has gone to great pains to buttress its argument that competitive rates will lead to destructive competition in the securities industry. Its arguments are quite complex.

First of all, the Exchange asserts that the average total cost per transaction incurred by a brokerage firm declines at a significant rate as a firm grows larger, partly because of high fixed costs, and partly because of economies of scale. Consequently, marginal cost is continuously below average total cost for a wide range of output. If rates were competitively set, the Exchange argues, prices would fall to marginal cost, which would be below average cost, and the firms in the industry would suffer losses.

The less diversified and less well capitalized firms would go bankrupt and an equilibrium state would be reached with a few well-capitalized diversified firms surviving. Size and diversification rather than efficiency would be the key to survival. Presumably, the surviving firms would be profitable, either because they were operating at a level where there were no longer economies of scale, or because they were tacitly agreeing to keep their prices at average cost or above. In order to justify their arguments, the NYSE includes in its August 1968 economic brief a fair amount of quite unpersuasive econometric analysis.\textsuperscript{110}

In its 1968 and 1969 briefs, the Exchange also attempted to demonstrate that the brokerage industry was exceptionally prone to destructive competition due to the erratic nature of the demand for its services.\textsuperscript{111}

\textsuperscript{110} For example, the Exchange sought to demonstrate, by including as “fixed costs” such items as clerical salaries, communication costs, occupancy and equipment costs, and “other expenses,” including promotion, licenses, dues, and assessments, that for the year 1966, fixed costs for the average firm constituted 51% of total costs. NYSE Economic Brief, Aug. 1968, supra note 98, at 64.

As the Justice Department pointed out, it was highly unrealistic for the NYSE to classify 75% of salaries of personnel as fixed costs. When volume or profits have declined in the past, brokerage firms have not hesitated to lay off employees. The brokerage industry is primarily a service industry, and it should have lower fixed costs than manufacturing industries and much lower fixed costs than industries which are traditionally regulated as public utilities. Dep't of Justice Memorandum, Jan. 1969, supra note 100, at 114-15.

In its 1968 economic brief, the NYSE also attempted to derive the average cost curve of the brokerage industry through two techniques. First of all, the Exchange found an inverse correlation between the rate of growth of member firms during the period 1965-66 and the direction in which their average unit costs were changing. In other words, rapid growth was associated with reductions in average cost. NYSE Economic Brief, Aug. 1968, supra note 98, at 55-58.

But, as Professor Baxter has pointed out, this correlation does not demonstrate that the brokerage industry has a declining cost curve. The data may simply suggest that efficient brokerage firms tend to grow. Alternatively, it may indicate that there are some economies of scale in the brokerage industry and that firms that had not yet fully achieved significant economies of scale were tending to realize them by growth. Baxter, supra note 103, at 697-98.

In addition, the Exchange ran a regression on total costs of output, which showed that the long-run average cost curve is negatively sloped over the entire range of outputs covered by firms in the data base. NYSE Economic Brief, Aug. 1968, supra note 97, at 58-63. Although the NYSE did not bother to calculate the steepness of the slope, Professor Baxter analyzed the Exchange’s data and discovered that costs drop quite sharply for firms that execute fewer than 200,000 transactions per year, but at larger outputs the rate of decline was insignificant. Thus, Professor Baxter argues that on the basis of the Exchange’s own data substantially more than 80 firms would survive the introduction of negotiated rates, a number far in excess of that necessary for effective competition. Baxter, supra note 109, at 698-99.

\textsuperscript{111} When demand reaches short-run peaks, the industry must have available adequate capacity to handle the load. This means that excess capacity must be tolerated during
Perhaps the most devastating blow to the Exchange's argument is the lack of destructive competition in the over-the-counter market and third market where rates are negotiated. Also, the bargaining of institutional traders for give-ups and other rebates in effect results in negotiated commission rates for a large number of customers. Thus, the NYSE in its defense of the fixed rate commission system was in effect defending a rate system which was and is to a large extent negotiated. Past experience has not indicated any tendency toward destructive competition among brokerage firms catering to institutions, which are in general the most profitable in the industry. Ironically, when the SEC initially proposed to eliminate give-ups by check, the NYSE defended give-ups.

The Exchange also emphasized the public interest in the financial solvency of brokerage firms and the possibility that bankruptcies might result in extensive loss of customer funds or securities held in "street name." At the end of 1970, Congress created the Securities Investor Protection Corporation which will insure each customer account up to $50,000, of which no more than $20,000 can be in cash. The SEC is also considering strict regulations which would require brokerage firms to carefully segregate their customers' money and securities from the rest of the firm's assets. If adopted, these regulations should ensure that customers will be fully protected in the event of a firm's insolvency.

In summary, although the Exchange pressed its destructive competition theory with great earnestness, its arguments are not convincing.

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periods of low demand and in fact should be actively encouraged. . . . We are not speaking here of any commission rate policy designed to foster a permanently redundant excess of supply. But commission rate fluctuations should not be such as to precipitate a reduction in capacity during periods of below-average demand." NYSE Economic Brief, May 1969, supra note 99, at 32.

The Exchange then argued that competitive commissions would approximate short-run, rather than long-run, marginal cost and that "competition would have the tendency to eliminate excess capacity at times of declining demand—capacity which must be available during the subsequent phase of recovery in demand." Id. at 36.

The Exchange's argument rests on the propositions that no queuing can be tolerated and the cost of excess capacity cannot be recovered through negotiated commission rates. However, queuing does occur and should occur to some extent. Even now, on a high volume day, it may be difficult for a client to reach his broker. With competitive rates, firms would maintain different degrees of excess capacity and charge appropriately different commission rates.

Additionally, it is unrealistic to assume that firms will constantly change their rates to reflect temporary variations in short-run marginal cost. See Baxter, supra note 109, at 702-03.


Mr. William McChesney Martin, Jr. in his report on the securities market stated that:

Fully negotiated rates may cause a substantial concentration of the securities business in a few large firms. Because of the strategic importance of the securities industry to the operation of the free enterprise-capitalistic system, control of this industry cannot be permitted to be concentrated in the hands of a few persons or firms. Such a concentration of power could not be tolerated even on the grounds of efficiency.

Negotiated rates may not have this effect. They may only serve to eliminate the inefficient, poorly managed broker-dealers. No one knows the answer to this question, but an abrupt change to fully-negotiated rates would be prudent at a time when the industry needs continued earnings to accumulate and attract capital.  

3. Price Discrimination

The NYSE also suggested that minimum commission rates protected small investors from price discrimination. If rates were negotiated, institutional investors would use their greater bargaining power to force rates for large orders down to variable costs. Brokers would be forced to shift overhead expenses to smaller investors with less bargaining power.  

To this argument the Justice Department retorted:

It must take a certain amount of fortitude to advance such an argument in the face of the "monopolistic discrimination" of the present rate system, which . . . requires the investor to pay substantially more than cost on all but the smaller trades . . . .

In fact, competition is the great eliminator of price discrimination since, in the long run, it tends to force prices into line with costs.  

Since there are large numbers of firms in the brokerage industry, price discrimination could not persist because no broker-dealer would handle a transaction at less than long-run marginal cost, no matter how large the client, and no customer would have to pay much more than long-run marginal cost because there would always be a competitive broker ready to handle his order at marginal cost.

The "price discrimination" argument assumes a certain homogeneity among broker-dealers. This, of course, is not the case. Therefore, negotiated rates on all orders should not lead to shifting of overhead expenses to the small investor.

4. Quality of Service

The Exchange also pointed out that negotiated commission rates would lead to unbundling and argued that it is desirable to tie together in-

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115. Martin Report, supra note 24, at 80,563.
formation, research, advice, promotional services, and execution. The NYSE insists that investment advice and research protects the small investor in the same way that consumer information protects the consumer. Investors should be allowed to obtain these services free, simply to encourage them to make more enlightened decisions, not only for their own protection but for the protection of the stock market and the economy from rampant speculation. Promotional activities should be encouraged to make more Americans aware of the benefits of stock ownership and also to increase individual participation in securities trading at a time when liquidity is threatened by increased institutionalization.

These arguments are easily rebutted. Tie-ins inhibit the freedom of the consumer to choose the mix of services he desires. Furthermore, competition in the markets for the separate services is inhibited. If commission rates were negotiated and unbundled, research might actually improve because a thriving and highly competitive market advisory system might develop.

Consumer protection is not an appropriate analogy, because a purchaser of a product such as an automobile is purchasing an item which is almost a necessity. Malfunctions in the product may severely inconvenience him or even endanger his life. An individual who purchases stock has deliberately chosen to play a game in which there is a danger of loss and the possibility of gain. It seems reasonable that the investor or speculator should be free to choose his own advisors in this game or even to have no advisors at all. Furthermore, the present bundled system encourages the stockbroker to exploit the unsophisticated investor. Because the stockbroker receives a fee for execution and not for research, he is tempted to encourage the customer to churn his account more frequently than is necessary. The best customer is the speculator who trades frequently, and registered representatives may well encourage their customers to speculate.

In summary, unbundling would be an advantageous rather than a disadvantageous result of negotiated commission rates.

In its Statement on the Future of the Securities Market, the SEC expressed concern about the issue of research as an element of the commission rate. The Commission stated:

In our opinion, the providing of investment research is a fundamental element of the brokerage function for which the bona fide expenditures of the beneficiary's funds is completely appropriate, whether in the form of higher commissions or outright cash payments. . . .

Concern has also been expressed that under an unbundled rate system many small investors would seek to obtain the lowest rates available and would lose the benefit of basic research now paid for by the minimum commission. In this regard, the Commis-
sion wishes to emphasize that a broker-dealer will not be relieved of his obligation to his customer with respect to the 'suitability' of a securities transaction. . . . Unarticulated but implicit in such rules is also the broker's obligation to obtain current basic information regarding the security and then to make an evaluation as to the suitability of a recommendation for a particular customer in view of both the information concerning the security and the customer's needs.

Vigorous enforcement of the standards of suitability . . . would thus mean that as competitive commission rates are introduced the basic execution charge which would evolve would include the provision of research services to the extent necessary to comply with these standards.118

The Commission's statement places much emphasis on the need for research to satisfy the suitability rules. However, the Commission seems to be saying that when a recommendation is given by registered representatives it must be backed by reasonable research. The Commission goes further to say that where a customer wishes to buy securities and requests no recommendation from the registered representative, the customer is entitled to receive from the registered representative any information that the broker-dealer has available to it.119 However, the Commission does not require that where the broker-dealer has no information on the particular stock, it must do adequate research before executing the customer's order. This would mean that broker-dealers may be set up whose only function is to execute the transactions so long as the customers realize that no research will be forthcoming. This is the present method of doing business for many block positioners and third market-makers. It would seem that under a system of negotiated rates the basic execution charge need not include a provision for research.

5. Summary

None of the Exchange's justifications of fixed commission rates are valid. The Justice Department's side of the extended NYSE-Justice debate is clearly the more persuasive. Fixed minimum commission rates are not "necessary to make the Securities and Exchange Act work"120 and are not desirable from a public policy point of view.

The fixed minimum commission rate has been the source of many of the problems that are currently plaguing Wall Street. High fixed rates have led to the whole question of whether institutions have a fiduciary obligation to join regional exchanges. Fixed rates have been the source of various reciprocal practices. Fixed commission rates have led to a fragmentation in the securities market and to the birth of the third mar-

119. Id.
Fixed rates have made the SEC a rate fixing agency—a role for which it is ill-suited. In short, fixed rates are not only unnecessary in making the Exchange Act work but have severely hampered the workings of an efficient securities market.

C. Practical Considerations

1. Unenforceability

Much of the theoretical debate between the NYSE and the Justice Department had an air of unreality, because the Exchange was defending an abstraction called the fixed commission rate structure which did not exist in practice. Reciprocity, floor give-ups, institutional memberships on regionals, and block-positioning have severely eroded the fixed commission rate structure.

The regional exchanges have been quite willing to act as conduits for rebates of NYSE commissions. Furthermore, as Professor Baumol has commented, it is highly questionable if the SEC could effectively stop reciprocal practices and rebates, even if it wished to do so. The present system is inequitable because investors vary in their ability to take advantage of the loopholes and because the rebates have a tendency to flow into the wrong hands. Under such circumstances, the so-called fixed commission rate structure does not seem worth preserving.

2. Difficulties of Rate Regulation

If the NYSE were to continue to set fixed commission rates, the SEC would be forced to regulate these rates like a public utility commission. Rate regulation is a difficult task at best, but there are special problems in the brokerage industry which make rational rate regulation virtually impossible.

Unlike most regulated industries, the brokerage industry is characterized by a multitude of firms which have great variations in their costs and their kinds of business. There is no regulatory control over exit, entry, and many aspects of a firm's operation. Furthermore, the sources of income of brokerage firms include such bizarre and difficult to allocate

121. As Professor Baumol commented in the Rate Structure Investigation Hearings: "Where a large number of suppliers is involved, whatever the nature of the regulations, no matter how severe the penalties imposed on their violation, ways are inevitably found for their evasion. . . . I know of no exception to the general principle— attempts to enforce any artificial price in the presence of a multitude of sellers leads inevitably to a patchwork of regulations, each designed to fill the holes left by its predecessors. . . . With such sub rosa market arrangements funds tend to flow into the wrong hands. Instead of their going to those who supply the service or to the consumer, they frequently go into some other pockets." SEC Rate Structure Hearings 3634 (Oct. 30, 1968).
items as margin interest, interest on free credit balances, and profits (or losses) from block positioning.

Brokerage firms are multi-product firms. In addition to NYSE business, they engage in regional-exchange business, over-the-counter business, underwriting, mutual fund distribution, arbitrage, trading, money-management, and many other activities. It is extremely difficult, if not impossible, to allocate the costs and capital of a firm among these various activities. Research costs, for example, help to generate income from trading, money management, and securities commission business. The registered representative in a regional office will do NYSE commission business, regional business, over-the-counter business, new issues, secondary distributions, and mutual fund sales. Moreover, once expenses are somehow allocated to NYSE business, they must then be divided into costs related to the order, the number of trades to execute that order, the value of the transaction, and other variables, to arrive at the commission schedule, which gives the fee for securities transactions of various sizes and value.

After the Justice Department challenged the legality of fixed commission rates in its April 1968 brief, the NYSE hired National Economic Research Associates to develop a rational cost-related commission schedule. NERA presented its report in 1970.\(^\text{122}\) Although NERA conscientiously attempted to perform its assignment, it was forced to make innumerable arbitrary decisions. For example, it appears that no attempt was made to determine whether or not partners' compensation might be excessive or might represent a return on capital.\(^\text{123}\) The classification of costs as order-related, trade-related, and value-related seemed highly arbitrary. Promotional costs, professional fees, dues and assessments, and research expenses were all classified as "value-related." Either no explanation or a circular one was offered for this allocation.\(^\text{124}\)

The NERA study attempted to arrive at an appropriate rate of return on capital for the brokerage industry by looking at rates of return for other industries of comparable risk. On an extremely intuitive basis, the study decided an after-tax return of 15 percent was appropriate for the brokerage industry.\(^\text{125}\)

The commission schedule finally proposed by NERA increased commissions on odd lots and trades of up to 200 shares and cut virtually all


\(^{124}\) See id., pt. IX, at 3-8.

\(^{125}\) See id., pt. VIII.
other commissions. The commission on 100 shares of $40 stock rose 68 percent, while it fell 30 percent on 1,000 share transactions. Although the net increases were greater than the cuts and were supposed to add about half a billion dollars in additional revenue to the industry, the report was bitterly attacked on all sides. The large institutional firms whose commissions were about to be cut drastically immediately criticized the new proposed commission schedule. The press almost unanimously condemned the increases in commissions on small trades. There were also Congressional murmurs of disapproval about the increased costs to the small investor. Although some retail houses were pleased by the proposed changes, they kept quiet; and some retail firms complained that the increases on small trades were too high and would drive away business.

Many members of the investing public, as well as some journalists and politicians, seemed to want to redistribute income between classes of investors by lowering rates for one class and raising rates for another class. The problem, of course, is that the brokerage industry is highly fragmented with firms specializing in different types of customers. Any attempt to “tilt” the rate schedule in favor of the small investor would result in excess profits for the institutional houses and losses for the retail firms.

After the initial brouhaha, the NERA Report quietly slipped into oblivion. On June 30, 1970 the NYSE, purporting to use the NERA Report as a basis, submitted to the SEC a proposed rate schedule. The NYSE’s Costs and Revenues Committee, among other things, (i) limited to 50% the increase on rates for orders up to $5,000; (ii) limited all rates to a maximum of $1.00 per share; and (iii) raised the NERA suggested rate on orders over $5,000 to make up for revenue lost by lowering rates on the smaller orders. The arbitrary alterations by the NYSE to the NERA proposal demonstrated the impossibility of attempting to devise and impose a reasonable commission rate. Since the NERA Report there has been no other attempt to rationally devise a set of reasonable cost-related commission rates for the industry.

3. NYSE President Haack’s Speech

In a speech before the Economic Club of New York on November 17, 1970, President Haack of the New York Stock Exchange dramatically and suddenly announced his support for negotiated commission rates. He indicated that practical considerations had forced him to reverse his former position.

126. Id., pt. II (c); vol. 2, Table XI, at 1-14.
127. See Thackray, supra note 122, at 49.
Concerning fragmentation and reciprocity he stated:

[F]ragmentation has been accelerated by the proliferation of reciprocal practices in the securities industry today which, in my judgment, are not only threatening the central marketplace but are tending to undermine the entire moral fabric of a significant industry as well. ... Bluntly stated, the securities industry, more than any other industry in America, engages in mazes of blatant gimmickry, all of which have been disclosed under oath at commission rate hearings. Deals are frequently involved, complicated, and bizarre and do no credit to the donor or beneficiary of the reciprocation.\(^{128}\)

... I personally think [the industry] might well reconsider fully negotiated commissions as an ultimate objective. The initial emphasis might be put on larger transactions ... I have altered my own personal thinking as a result of the commission rate proceedings of the last two years and the fragmentation of markets that has simultaneously been increasing. ...

[In] view of the increased emphasis that rates be reasonable, there is the concomitant responsibility to set standards by one method or another. ... I believe the securities industry is being led down the path of utility-type regulation when it possesses none of the characteristics of a utility.\(^{129}\)

President Haack conceded that fixed rates had perhaps brought about the same kind of self-destruction that the industry had feared would result from regulated rates. "I inquire of myself," he said, "as to whether overly-zealous service-type competition and inept management has not been fostered by minimum commission rates."\(^{130}\) President Haack further acknowledged that putting an end to the fixed commission system could help solve the problem of institutional membership, because the incentive to seek rebates on large commissions would be greatly diminished.\(^{131}\)

Concerning unbundling, President Haack said that he questioned the propriety of one commission rate serving all customers without regard to their individual wishes, needs or requirements for varying degrees of service.\(^{132}\)

Finally, President Haack stated that the negotiation of rates on regional exchanges and the third market "make a mockery of the fixed minimum rate concept," and have brought about various reciprocal practices which mean that some customers pay only a fraction of the fixed schedule. He continued:

I inquire as to whether the fixed rate concept, providing the basis for reciprocity and concurrently developing an incentive for institutions to recapture all or part of commissions paid, is not the single greatest reason for our market fragmentation. We can compete in only two areas, namely, service and charges, and I submit that no entity,

\(^{128}\) Address by President Haack, Economic Club of New York, Nov. 17, 1970, at 6.

\(^{129}\) Id. at 8.

\(^{130}\) Id. at 9.

\(^{131}\) Id. at 9-10.

\(^{132}\) Id. at 9.
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not even the New York Stock Exchange, can forever ward off competition from a non-
competitive stance so far as pricing is concerned.133

Although Mr. Haack's views were promptly attacked by many leaders
of the financial community, his comments on the "fixed" commission
rate were extremely perceptive. The controversy over the desirability of
negotiated rates still rages within the industry. There are still a great
many leaders of the Wall Street community who refuse to face reality
and still support the fixed commission rate system. The fixed commission
rate system is unenforceable, and even if it were enforceable, it would
be impossible for the SEC to find standards by which to regulate rates
in the industry.

D. Toward Negotiated Commission Rates

The Department of Justice stated in January, 1969 that "the sys-
tem of fixed minimum commissions is not justified or needed 'to make
the Securities Exchange Act work.' "134 In February, 1971, the SEC
directed that the national securities exchanges eliminate fixed rates "on
portions of orders above a level not higher than $500,000."135 The ex-
changes implemented the Commission's order in April, 1971. One year
later, the breakpoint for competitively determined commissions was
dropped to $300,000. When the SEC directed this reduction in its Feb-
ruary, 1972 Statement on the Future Structure of the Securities Market,
it announced that it would "continue to observe the experience under
the $300,000 level in considering the timing of subsequent steps."136

Elements in Congress agree that commission rates should be competi-
tively determined. On February 4, 1972, the Senate Committee on Bank-
ing, Housing and Urban Affairs released its report on the securities
industry, in which it remarked that "the interests of the investing public,
as well as the long-term health of the securities industry itself, require
that stock exchange members be free to set their own commissions on
transactions effected for their customers ...."137

The Subcommittee on Commerce and Finance of the House Committee
on Interstate and Foreign Commerce released its report on the securities
industry on August 23, 1972. In its report the Subcommittee stated that

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133. Id. at 10.
134. Dep't of Justice Memorandum, Jan. 1969, supra note 100, at 13.
the SEC had announced its conclusion that "fixed charges for portions of orders in excess
of $100,000 are neither necessary nor appropriate." Id., No. 9007 (Oct. 22, 1970).
136. SEC Statement, supra note 42, at 33.
137. Senate Comm. on Banking, Housing and Urban Affairs, Securities Industry Study
“fixed minimum commission rates are not in the public interest” and recommended “that a competitive commission rate system should be phased in without excessive delay.” The Subcommittee said that the competitive system “should apply to all transactions, regardless of size,” and warned that “if reasonable progress toward the elimination of fixed minimum rates is not being made, we are prepared to take legislative action to achieve this end.”

VIII. AUTOMATION

Perhaps the greatest threat to the continued existence of the New York Stock Exchange as presently constituted is automation. In the past several years a number of different automated securities trading systems have begun operation. Perhaps the most important of these systems has been the National Association of Securities Dealers Automated Quotation System (NASDAQ).

On February 8, 1971, the entire over-the-counter market was dra-
matically revolutionized by the introduction of NASDAQ. Virtually every firm which deals in the over-the-counter market subscribes to the system. At its inception, NASDAQ supplied quotes on 2,400 leading OTC stocks, although it has the capacity to handle up to 20,000 stocks. NASDAQ permits dealers to display their quotes and eliminates the time consuming need to constantly telephone one another.143

In 1968 the by-laws of the NASD were specifically amended by vote of the full membership to include listed securities in the proposed NASDAQ system.144 On October 9, 1970, Ralph Saul, the then President of the American Stock Exchange, wrote the SEC to seek to prevent the inclusion of listed stocks on NASDAQ. On October 13, 1970, NYSE President Haack, a former head of NASD, wrote a similar letter. These two letters were followed by a third letter from Gordon S. Macklin, President of the NASD, making a similar request. SEC Chairman Budge wrote back to Mr. Macklin stating that the Commission would have no objection if the NASDAQ system did not include listed securities. President Macklin, with the approval of the NASD Executive Committee, then announced that NASDAQ would not carry listed stocks at its inception.145 All six members of the Executive Committee were partners or officers of NYSE firms, and 16 of the 23 members of the NASD Board of Governors were representatives of NYSE firms.

143. NASDAQ provides service on three levels. Level I supplies representative, or median, bid and ask quotations to the desk-top video terminals already on the desks of registered representatives ("customers' men") in retail branch offices of brokerage firms.

The retail trading firm executing orders for public investors will subscribe to Level II. A subscribing dealer is able to enter the symbol for a stock and immediately view on his video screen the offers of the firms making a market in that stock. Next to each quotation is the symbol of a market-maker.

The Level III subscriber is the market-maker himself, who is the only subscriber permitted to put data into the system. For those securities for which he has qualified as a market-maker, the Level III subscriber can enter, withdraw, and change bid and ask quotations, which are instantly made available to other Level II and Level III subscribers.

On the basis of the quotations displayed on their video-terminals, retail firms will contact market-makers by telephone to arrange an execution.

Each Level III subscriber, as a condition of registration as a market-maker, must agree to report at the end of the trading day the volume of shares he has traded in each of the securities in which he makes a market. His terminal device is equipped to accept this volume information. After each market-maker in a security has reported, the computer summarizes the reports by security and issues them to the news media along with the exact closing bid and ask price of each security. During the day the computer also calculates a composite OTC market index and updates it hourly.


In December 1970, Shumate & Company, a small over-the-counter firm located in Dallas, Texas, filed an antitrust treble damage suit charging that the NASD, the NYSE member firm of Shearson, Hammill & Co., and other NASD members who belonged to national securities exchanges had conspired, combined and agreed to illegally restrain trade in the purchase and sale of third market securities by excluding NYSE listed securities from NASDAQ.\textsuperscript{146} Third market firms also protested the NASD Executive Committee decision.\textsuperscript{147}

On March 14, 1971, about five weeks after NASDAQ commenced operations, the NASD Board of Governors voted unanimously to conduct a test-listing of listed securities for a period of 90 to 180 days commencing April 5, 1971. Thirty-six stocks, 32 from the NYSE and two each from the Amex and the Midwest, were included in the test.\textsuperscript{148}

On April 5, 1971 the number of NYSE stocks was reduced to 30 and the number of American Stock Exchange stocks to one; but the test was implemented. Seven weeks after the beginning of the experiment NASDAQ trading of listed securities was already putting serious pressure on the Exchange; because for the first time third market quotations were as accessible as floor quotes.\textsuperscript{149} One early survey of the thirty Big Board stocks on NASDAQ showed that third market prices were superior to Exchange prices in about a third of the comparisons, and equal to floor prices in about one fourth of the cases. A small but growing number of member firms, including Merrill Lynch, were actively making comparisons between the Exchange and NASDAQ and using the third market \textit{via} regional exchanges when the price was right. In late May 1971, Weeden & Co., the leading third market firm, reported that its business with member firms had risen ten percent as a result of the new access to its quotations through NASDAQ.\textsuperscript{150}

Since Weeden & Co. is a member of several regional exchanges, NYSE member firms that are members of one of these two exchanges can negotiate a transaction with Weeden & Co. and then cross it on a regional exchange without being forced to charge Weeden a NYSE commission and without violating Rule 394.\textsuperscript{151}

\textsuperscript{148} N.Y. Times, Mar. 15, 1971, at 55, col. 3.
\textsuperscript{150} Id.
\textsuperscript{151} As mentioned in the earlier discussion of Rule 394, even if a third market-maker is not a member of a regional, he can still deal with a dual member by interpositioning a
If Rule 394 were eliminated, NASDAQ might gradually supplant the New York Stock Exchange. If it were to survive, the Exchange would certainly be forced to adopt technological innovations it should have implemented long ago.

A fully automated, and possibly merged, NYSE and American Stock Exchange with negotiated rates would be almost identical to NASDAQ, except that the organized exchanges would have only one market-maker in each security, and these specialists would have certain public responsibilities. If there is more than one market-maker, it becomes impossible to determine which one has the obligation to dampen market fluctuations. On the other hand, if there are competing market-makers, regulation may not be necessary.\textsuperscript{152} The large number of market-makers might maintain a reasonably stable market simply by going against the public to the extent that they feel this is profitable in the long run. Bid-ask spreads would remain narrow as each market-maker attempted to give higher bid and lower ask quotations than his competitors. Furthermore, both the SEC \textit{Special Study Report}\textsuperscript{153} and the \textit{Institutional Investor Study}\textsuperscript{154} raised questions about the efficacy of NYSE and SEC regulation of specialists, as opposed to the control induced by competition.

In its transmittal letter accompanying the \textit{Institutional Investor Study} the SEC stated:

The participation of competing dealers in the central market will also reduce the element of monopoly power which has accompanied past efforts to establish a central market and will make it possible for potential abuses of such monopoly power to be controlled not only by regulation but to an increasing degree by competition.\ldots

In summary, our objective is to see a strong central market system created to which all investors have access, in which all qualified broker-dealers and existing market institutions may participate in accordance with their respective capabilities, and which is controlled not only by appropriate regulation but also by the forces of competition.\textsuperscript{155}

The SEC's \textit{Statement on the Future Structure of the Securities Market} addressed itself to competing market-makers. It stated:

The Commission believes that the liquidity needs of individual and institutional investors can best be provided by policies fostering the development of competition among dealers who are specialists, market-makers and block positioners. Such competition will mitigate the very difficult problem which now exists of developing and

\textsuperscript{152} See Wolfson and Russo, \textit{The Stock Exchange Specialist}, 1971 Rev. of Sec. Reg. 891.


\textsuperscript{154} See note 3 supra.

\textsuperscript{155} SEC, \textit{Letter of Transmittal, Institutional Investor Study}, supra note 3, pt. 8, at XXIV-V.
enforcing rules designed not only to prevent specialists from abusing their privileged position, but also to motivate them to perform satisfactorily under widely differing circumstances and in the light of varying risks and pressures.\footnote{156. SEC Statement, supra note 42, at 16; See Wolfson and Russo, Let the Specialist Compete-Regulation Won't Solve Exchanges' Problems, N.Y. Times, Oct. 3, 1971, § 3, at 14, col. 3.}

Thus it is clear that the Commission's emphasis is on competition among market-makers. Such competition is found on NASDAQ and not on the floor of the NYSE.

The advent of NASDAQ has raised anew the question concerning the fiduciary obligation of the broker to obtain best execution. In the 1936 Segregation Report of the Securities and Exchange Commission, it was stated that "the relationship between broker and customer is fiduciary in nature. The legal incidents of that relationship are well-established in existing law . . . . [H]e is required to exercise the utmost fidelity and integrity."\footnote{157. SEC, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker (1936).} As noted earlier\footnote{158. See text accompanying note 92 supra.} the 1965 Staff Report of the Securities and Exchange Commission on Rule 394 also placed considerable emphasis on this fiduciary duty.

If there was an argument at the time of the 1965 Staff Report on Rule 394 that the broker had an obligation to check to see if it could receive a better price for its customer, it seems clear that NASDAQ has added a new dimension to that conclusion. With the press of a button on NASDAQ a NYSE broker could find out if a better price could be received in the third market. In those cases where the third market-maker is not a member of any regional exchange, Rule 394 would lead to a violation of the principle of best execution.

The basic intent of the brokerage relationship is that the broker fulfill his obligation of best execution to the customer. It therefore seems apparent that to the extent rules such as NYSE Rule 394 prevent a broker from obtaining the best execution for its customer, they are clearly unreasonable and against public policy.

In answer to this problem it has been argued that by executing trades in the third market fragmentation will result. Fragmentation, it is claimed, defeats the concept of a central market system. The fact is that real fragmentation results by not checking NASDAQ because a full picture is not seen.

As more volume leaves the NYSE, the specialist's dealer function of maintaining continuity with depth becomes increasingly difficult. Al-
though this is unfortunate, it should not be used as justification for keeping volume on the New York Stock Exchange. Instead, the Exchange should facilitate market-making competition and, in so doing, achieve narrower spreads between bid and ask and bring about continuity with depth in the entire market. Competition will also pressure all market-makers to assume larger positions.

NASDAQ, together with the third market, has been the single most powerful threat to the New York Stock Exchange's dominance since its founding in 1792. Recently, the Philadelphia-Baltimore-Washington Stock Exchange has requested that its specialists be placed on the NASDAQ system. If this is done other regional exchanges will, no doubt, follow. This would be another major step towards the growth and dominance of the NASDAQ system.

There can be little doubt that NASDAQ has caused a basic restructuring of the market. It has set up the mechanism for a truly competitive central market system where all broker dealers may participate. NASDAQ, however, does not have provision for the "book" in which all public orders may be represented. Once such a book is placed in the NASDAQ system the system will have the benefits of the auction market together with the advantages of competitive market-makers.

At present NASDAQ is a communications and information retrieval system only. In the future it should also be possible for negotiations, executions, clearance, and confirmations to take place through the system. This would mean a truly efficient and competitive securities market.

IX. CONCLUSION

Institutional dominance of securities trading has shifted the balance of bargaining power to the customers and away from brokerage firms. Furthermore, the antitrust immunity of the Exchange is being severely questioned by both the Justice Department and Congress. The SEC has also become increasingly aware of the benefits competition can bring to the forming of an efficient securities market.

This article has discussed a number of the monopolistic practices of the New York Stock Exchange, including limitations on the number of

159. In its August, 1972 Securities Industry Study Report the House Subcommittee on Commerce and Finance stated: "Although the actual details of developing a consolidated tape and composite quotation system should be left to the Commission, the overall characteristics of such a system should be delineated by appropriate legislative guidelines. The duty to make timely reports of transactions within the central market system should be imposed by statute; the precise contents of such reports and the method of their dissemination to the public could be provided by rule or regulation." Securities Industry Study, supra note 1, at 125.
"seats," prohibition of institutional membership, Rule 394, and fixed minimum commission rates.

Many of the problems regarding the structure of the securities industry are centered around the fixed commission rate. The fixed rate has led to numerous inefficiencies, to the issue of institutional membership, and the Byzantine reciprocity practices in the industry. The fixed rate together with other monopolistic practices has subverted the goal of best execution to the economic self-interest of the New York Stock Exchange. It shelters inefficiency while at the same time giving the well-managed firms excess profits.

The New York Stock Exchange has taken every opportunity to fight competition. It sought to prevent listed securities from being included on NASDAQ. It has recently refused to have competition in the specialist function. It has instituted Rule 394 to prevent competition from the third market. It has, in short, made every attempt to insulate its monopoly status. Fixed commission rates and other monopolistic practices of the NYSE endanger the efficiency of the securities market. These practices are certainly not “necessary to make the exchange work,” and should be declared violations of the antitrust laws.

The sweep of technological innovation may resolve many of these problems. The New York Stock Exchange, unless it changes its philosophy, could well be replaced by a vigorously competitive computerized over-the-counter market with negotiated commission rates and virtually no limitations on membership or access.