

Regulation of the Compensation of Securities Dealers

David L. Ratner

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REGULATION OF THE COMPENSATION OF SECURITIES DEALERS*

David L. Ratner†

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The compensation structure of the securities business is being challenged from many directions. The Justice Department has questioned the need for fixed minimums on stock exchange commissions

* As noted in the opening paragraph, this area of regulation is in a period of rapid change; the statements herein are current as of January 20, 1970.

A revised version of this article is expected to be included in a book on the regulation of securities dealers, to be published by McGraw-Hill.

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and the Securities and Exchange Commission is holding extensive hearings to determine whether and in what form they can be justified. Congress is considering legislation to control sales loads on mutual fund shares. The National Association of Securities Dealers found "unfair or unreasonable" underwriting compensation in more than fifteen percent of the new issues it reviewed in 1968. And the securities business itself is complaining that its charges on small transactions are inadequate to cover its costs.

The following summary of the complex of regulations governing compensation in the securities business may help to explain some of the dissatisfaction with the current situation, as well as pointing toward possible areas for change.

I

SOURCES OF INCOME OF BROKER-DEALERS

The securities business is essentially a service business. Some of the transactions in which broker-dealer firms engage take the form of principal transactions, but basically such firms act as intermediaries between buyers and sellers of securities—members of the public, institutional investors, and the issuers of the securities themselves. Broker-dealers receive compensation from a variety of activities, each of which is subject to distinct regulations and limitations. A study done for the National Association of Securities Dealers (NASD) showed that its members in 1964 obtained about forty-four percent of their income from stock exchange commissions, seventeen percent from over-the-counter transactions, eight percent from mutual fund sales activities, six percent from corporate underwritings, and the remaining twenty-five percent from miscellaneous other sources, including interest on customers' margin accounts, commodity transactions, advisory fees, and service charges.¹ The compensation mix varied greatly from firm to firm, with the larger firms deriving a greater proportion of their income from stock exchange commissions, the small-to-medium firms deriving the greatest proportion from over-the-counter activities, and the smallest firms receiving most of their income from the retailing of mutual fund shares.²

¹ BOOZ, ALLEN & HAMILTON, INC., OVER-THE-COUNTER MARKETS STUDY 13 (1966) [hereinafter cited as OTC STUDY]. See also NEW YORK STOCK EXCHANGE, 1969 FACT BOOK 57.

² OTC STUDY 13.

II

STOCK EXCHANGE TRANSACTIONS

A. *Fixed Minimum Commission Rates*

Commissions on stock exchange transactions are based on schedules of minimum commissions established by the national securities exchanges and binding on their members. The commission rate schedules of the various exchanges are substantially identical, so that a firm that is a member of several exchanges must charge the same commission to a customer for a particular transaction regardless of on which exchange it is executed.³ Since New York Stock Exchange (NYSE) transactions account for approximately eighty percent of the dollar volume of all exchange trading,⁴ the following discussion is based on the NYSE rules, with appropriate indications of variations to be found in the rules of other exchanges.

1. *Scope of Restriction*

The stock exchange rules prescribe minimum commission rates, and there is generally no legal restriction against members charging higher rates. As a practical matter, however, member firms seldom charge more than the minimum rate for services to which the rate schedule applies.⁵

The commission rate schedule is divided into two distinct parts: (1) a schedule of rates to be charged by members to non-members for effecting a complete transaction on the exchange⁶ and (2) a schedule

³ The New York Stock Exchange [NYSE], American Stock Exchange [AMEX], Midwest Stock Exchange [MSE], and Pacific Coast Stock Exchange [PCSE] rules state that in the event of a conflict as to commission rates to be charged, their members may follow the rates prescribed by the exchange where the transaction occurred. NYSE CONST. art. XV, § 1; AMEX CONST. art. VI, § 1; MSE rules art. XXVIII, rule 19; PCSE rule IV, § 3(f). A NYSE member which is also a member of a regional exchange (*i.e.*, an exchange located outside the City of New York) is permitted to deal in all securities listed or traded on such other exchange, including securities dually listed on the NYSE. NYSE CONST. art. XIV, § 8. The AMEX rules also permit member trading of dually-listed AMEX securities outside the City of New York. AMEX CONST. art. V, § 4(g). The SEC found in 1941 that "irreparable damage" would result to the regional exchanges if the NYSE prevented its members from dealing on another exchange in securities dealt in on the NYSE, and ordered the NYSE constitution amended to permit such dealing. The Rules of the NYSE, 10 S.E.C. 270 (1941) (The Multiple Trading Case).

⁴ SEC Securities Exchange Act Release No. 8239, at 4 n.2 (Jan. 26, 1968).

⁵ See generally ASSOCIATION OF STOCK EXCHANGE FIRMS, COMMISSION TABLES FOR TRANSACTIONS ON THE NEW YORK STOCK EXCHANGE AND THE AMERICAN STOCK EXCHANGE.

⁶ "Non-member" is usually defined as any party not a member or allied member of an exchange, and includes professional brokers as well as ordinary customers. NYSE CONST. art. I, § 3(e).

of rates to be charged by members to one another for the various steps involved in the complete transaction.

The minimum rate to be charged to non-members applies to all non-members, including those engaged in the securities business. Since the rules of the exchanges generally prohibit members from executing transactions in listed stocks off the floor of an exchange,⁷ this in effect places a minimum on the commission that a member firm may charge a non-member firm for effecting a transaction in a listed security.

2. *Non-Member Rates*

a. *Services Covered.* The minimum rate to be charged to a non-member is an all-inclusive rate, covering the execution and clearance of the transaction, arrangements for the registration and delivery of the securities, and basic research and custodial services. The exchanges generally impose restrictions, however, on the additional services that a member firm may perform for a customer without charging additional fees,⁸ on the ground that these may constitute rebates of the minimum commission.⁹

If both the buyer and seller are non-members, two full commissions must be charged, even where the same firm acts as broker for both parties to the transaction.

b. *Basic Rate.* The commission to be charged to a non-member for the execution of a transaction in listed stocks, rights, or warrants is based on the "money involved" in a "single transaction." On stocks selling for one dollar per share and above, the basic rate is three dollars plus

2% on first \$400 of money involved, plus
 1% on next \$2,000 of money involved, plus
 1/2% on next \$2,600 of money involved, plus
 1/10% on money involved above \$5,000.¹⁰

Under this formula, the minimum commission for buying or sell-

⁷ See NYSE rules 394, 395, 396; AMEX rule 187; MSE rules art. XXII, rule 6; PCSE rule XIII, § 2.

⁸ Examples of prohibited arrangements are unusual interest rates or money advances or assumption of stamp taxes or office expenses by a member, NYSE rule 369; certain types of statistical and investment advisory services, NYSE rule 440; supplementary material and certain office space arrangements, NYSE rule 343. The regional exchange rules contain similar prohibitions. AMEX CONST. art. VI, § 5; MSE rules art. XXVIII, rule 16; PCSE CONST. art. XIV, § 1.

⁹ See NYSE CONST. art. XV, § 1.

¹⁰ NYSE CONST. art. XV, § 2(a)(1); AMEX CONST. art. VI, § 2(a); MSE rules art. XXVIII, rule 2(a); PCSE rule IV, § 1(a)(1).

ing one hundred shares of a high-priced stock is greater than the commission for buying or selling one hundred shares of a low-priced stock but is a smaller percentage of the "money involved." For example, the minimum commission for buying or selling one hundred shares of stock selling at \$20 a share is \$27, or 1.35 percent of the money involved; for one hundred shares of a \$40 stock, it is \$39, or 0.98 percent of the money involved; and for one hundred shares of an \$80 stock, it is \$47, or 0.5 percent of the money involved.

Although this formula on its face appears to provide a substantially lower rate for large transactions, each one hundred shares or less included in an order is deemed to be a separate, "single transaction" to which the formula is to be applied.¹¹ Thus the minimum commission on a single order to buy or sell 200 shares of a \$40 stock is \$78, or two times \$39, and on a single order to buy or sell 1,000 shares it is \$390, or ten times \$39. A customer who wants to invest \$4,000, therefore, must pay a commission of \$54 if he buys 200 shares of a \$20 stock as against \$39 if he buys one hundred shares of a \$40 stock.

c. *Lower Rate on Large Orders.* Prior to December 5, 1968, the above rate applied to all orders without limitation as to size, so that the minimum commission on a single order to buy or sell 100,000 shares of a particular stock was 1,000 times the commission on one hundred shares of the same stock. However, the volume of large block transactions in listed stocks,¹² particularly by institutional investors,¹³ had been rapidly increasing, and the SEC's public hearing on stock exchange commission rates disclosed that substantial portions of the commissions on institutional business were being "given up" to broker-dealer firms and other persons who had no connection with the execution of the transactions.¹⁴ Consequently, the national securities exchanges were required to put into effect on December 5, 1968, an "interim" revised minimum commission rate schedule providing substantially lower rates for the portion of an order that exceeds 1,000 shares.¹⁵ The modified rate for each "single transaction" of one hundred shares or less after the first 1,000 shares is:

¹¹ NYSE CONST. art. XV, § 2(d)(1); AMEX CONST. art. VI, § 2(f); MSE rules art. XXVIII, rule 2(d)(1); PCSE rule IV, § 1(b).

¹² In 1968 on the NYSE there were 11,254 transactions involving 10,000 or more shares, accounting for 10% of reported volume. NYSE, 1968 ANN. REP. 15.

¹³ It is estimated that at present approximately 50% of non-member volume on the NYSE is transacted by institutions. SEC, 1968 ANN. REP. 3.

¹⁴ See text accompanying notes 38-62 *infra*.

¹⁵ NYSE CONST. art. XV, § 2(a)(2); AMEX CONST. art. VI, § 2(a)(2); MSE rules art. XXVIII, rule 2(a)(2); PCSE rule IV, § 1(a)(2). It was estimated that the new volume discount on orders over 1,000 shares would reduce brokerage commissions about \$150 million in 1969. SEC, 1968 ANN. REP. 2.

<i>Money Involved</i>	<i>Commission</i>
\$100 to \$2,800	1/2% of money involved plus \$4
\$2,800 to \$3,000	compute as for \$2,800
\$3,000 to \$9,000	1/2% of money involved plus \$8
Above \$9,000	1/10% of money involved plus \$39

Thus the minimum commission on a purchase or sale of 10,000 shares of a \$40 stock is now \$2,460 $[(10 \times \$39) + (90 \times \$23)]$ as compared with \$3,900 $(100 \times \$39)$ under the previous formula. The interim rate also provides that the minimum commission on any order, no matter how large, cannot exceed \$100,000.¹⁶

An "order" is deemed to include all purchases or sales for one account, of a single security, on the same day, pursuant to a single order.¹⁷ When a large order from a customer is executed over a period of several days, each day's executions are considered a separate "order" for the purpose of computing the minimum commission. Where parts of a single order from a customer to a broker are executed on different exchanges, the regional stock exchanges will permit the lower rate to be charged on the portion in excess of 1,000 shares regardless of the exchange on which executed.¹⁸

d. *Odd Lots.* The minimum commission on the purchase or sale of less than one hundred shares¹⁹ is generally fixed at two dollars less than the commission on a one hundred share transaction involving the same amount of money. An odd-lot transaction is automatically executed between the customer and the odd-lot dealer at the price of the next round-lot transaction in the stock. In addition to the commission charged by the customer's broker, the odd-lot dealer charges the customer a "differential" of one-fourth point (25 cents) on stocks selling at \$55 or higher and one-eighth point (12.5 cents) on stocks selling below \$55.²⁰

¹⁶ NYSE CONST. art. XV, § 2(f); AMEX CONST. art. VI, § 2(h); MSE rules art. XXVIII, rule 2(f); PCSE rule IV, § 1(d). One NYSE member advertised that it acted as broker for both buyer and seller in a NYSE transaction on May 4, 1967, involving 585,600 shares of Sperry Rand at a price of \$30.75 a share. N.Y. Times, May 8, 1967, at 64. Under the then-existing rates, the minimum commissions to be charged by the firm on that transaction totaled \$402,600. Under the new rate schedule, the minimum commissions would total \$200,000.

¹⁷ NYSE CONST. art. XV, §§ 2(d)(2), (3); AMEX CONST. art. VI, § 2(f)(2); MSE rules art. XXVIII, rule 2(d)(w); PCSE rule IV, § 1(b)(2).

¹⁸ E.g., MSE rules art. XXVIII, rule 2(j).

¹⁹ For minimum rates on 100-share lots, see text accompanying notes 10-11 *supra*. A "unit of trading" is usually 100 shares and any number below 100 is an odd lot. However, certain stocks have "units of trading" of 10 or even 50 shares as fixed by the various exchanges. NYSE rule 55; AMEX rule 120; MSE rules art. IV, rule 6; PCSE rule 1, § 7(a).

²⁰ NYSE rule 125. The present \$55 "break point" was adopted by the NYSE in June 1966. Between 1942 and 1966, the "break point" was \$40 and had been established not by the Exchange but by the two NYSE member firms that handle all odd-lot transactions on

e. *Special Types of Securities and Transactions.* Special rules prescribe minimum commission rates for shares selling below one dollar,²¹ for bonds,²² for "when issued" or "when distributed" transactions,²³ and other special circumstances.

3. *Intra-Member Rates*

Exchange rules also prescribe minimum commissions to be charged by members to other members for various services in connection with the execution of transactions. The minimum commissions for floor brokerage and clearance range from 1.85 cents a share for shares selling between one dollar and two dollars to 9.30 cents a share for shares selling at \$200 and above;²⁴ minimum commissions for floor brokerage alone range from 1.15 cents a share for shares selling between one dollar and two dollars to 4.65 cents a share for shares selling at \$200 and above;²⁵ and minimum clearing charges range from 0.30 cents a share for shares selling between fifty cents and one dollar to 3.00 cents a share for shares selling at \$50 and above.²⁶

B. *Rates and Services to Non-Member Professionals*

The NYSE rules prohibit member firms from charging lower commissions to non-member broker-dealers than to other customers, and the rules endeavor to set precise limitations on the services member firms may perform free or at less than cost for non-member professionals.²⁷ For example, there are specific limitations on the furnishing of office space, investment advice, and private wire services, as well as a general

that Exchange. A class action is presently pending against those two firms, alleging that they combined and conspired to monopolize odd-lot trading and fixed the odd-lot differential at an excessive amount in violation of the Sherman Act. *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555 (2d Cir. 1968). The "break point" on AMEX transactions is still \$40. For the rules on other exchanges, see AMEX rule 204; MSE Summary of Rules, § 14; PCSE rule 1, § 8.

²¹ NYSE CONST. art. XV, § 2(a)(3); AMEX CONST. art. VI, § 2(a)(3); MSE rules art. XXVIII, rule 2(c)(2); PCSE rule IV, § 1(a)(3).

²² NYSE CONST. art. XV, § 3; AMEX CONST. art. VI, § 2(d); MSE rules art. XXVIII, rule 3; PCSE rule IV, § 1(f).

²³ NYSE CONST. art. XV, § 5; AMEX CONST. art. VI, § 2(i); MSE rules art. XXVIII, rule 5.

²⁴ NYSE CONST. art. XV, § 2(b)(1); AMEX CONST. art. VI, § 2(b); MSE rules art. XXVIII, rules 2(b), (c)(1); PCSE rule IV, § 4(a).

²⁵ NYSE CONST. art. XV, § 2(b)(3); AMEX CONST. art. VI, § 2(b); MSE rules art. XXVIII, rule 2(c)(1); PCSE rule IV, § 4(b).

²⁶ NYSE CONST. art. XV, § 4; AMEX CONST. art. VI, § 2(b); MSE rules art. XXVIII, rule 2(b); PCSE rule IV, § 4(a). NYSE interpretation permits member firms to charge correspondents not less than 21% of the non-member rate rather than computing the special rate for each transaction.

²⁷ See NYSE CONST. art. I, § 3(e); *id.* art. XV, § 1.

prohibition against offering other types of services unless the cash compensation is sufficient to cover all direct and indirect costs of the service or unless the service is contingent on the non-member giving the member firm commission business and the cash charge covers all costs of creating, producing, and distributing the service.²⁸

1. *Reciprocal Business Arrangements*

Since these rules effectively prevent NYSE non-members from deriving direct compensation from transactions in listed securities which are executed for their customers on the NYSE,²⁹ reciprocal dealing arrangements have been established between NYSE-member and regional exchange-member firms. The NYSE-member firm, which is also a member of a regional exchange, usually agrees to give one dollar of commission to the regional exchange-member firm for each two dollars in commissions on transactions in listed securities it receives from the latter.³⁰ Prior to December 5, 1968, reciprocity often took the form of the NYSE-member firm executing transactions in dually-listed securities on a regional exchange of which it was also a member, and "giving up" a portion of the commission to the regional firm.³¹ Since the prohibition on "give-ups,"³² reciprocity has taken the form of NYSE members placing orders with regional exchange members for execution of transactions in dually-listed stocks on the regional exchanges.³³ In May 1969, however, the NYSE advised the SEC that some of these reciprocal arrangements appeared to violate the NYSE rules against rebates and that it was considering prohibiting reciprocal arrangements.³⁴

2. *Discounts*

The NYSE recently announced that it is considering a rule change permitting its members to give a discount, amounting to perhaps one-

²⁸ See note 8 *supra*.

²⁹ The non-member must pay the member the NYSE minimum commission and will usually receive no more than the minimum commission from his own customer.

³⁰ These arrangements in 1968 resulted in the NYSE giving out \$19.9 million in regional business in return for \$34.4 million in NYSE business. Wall St. J., June 10, 1969, at 4, col. 1.

³¹ Wall St. J., July 3, 1968, at 17, col. 3.

³² NYSE CONST. art. XV, § 1; AMEX CONST. art. VI, § 1; MSE rules art. XXVIII, rule 12; PCSE rule IV, § 1(a). See text accompanying notes 38-62 *infra*.

³³ Wall St. J., Jan. 9, 1969, at 1, col. 6. See also note 54 *infra* and accompanying text.

³⁴ Wall St. J., May 5, 1969, at 6, col. 2. NYSE rule 382 requires a member to file written information concerning any direct or indirect reciprocal arrangement related to NYSE listed commission business involving any NYSE member, broker or dealer, bank, trust company, mutual fund, etc. Each arrangement is subject to Exchange approval.

third of the commission, to "qualified" non-member broker-dealers.³⁵ The American Stock Exchange (AMEX) already admits qualified broker-dealers to "associate membership" entitling them to have transactions executed on the AMEX at special intra-member rates that range from about twenty percent to one hundred percent above the rates charged to regular members for comparable services³⁶ but are considerably below the rates charged to non-members. For example, the commission charged to an associate member for execution and clearance of one hundred shares of a \$20 stock is \$10.75, as compared with \$6.90 to a regular member and \$27 to a non-member. The initiation fee for an associate member is five percent of the last sale price of a regular membership, but not less than \$1,000.³⁷

C. Recent Developments Regarding Commission Rates

1. Institutional Investors and the Growth of "Give-Ups"

Prior to December 5, 1968, the minimum commissions on large transactions were simply multiples of the minimum commissions for one-hundred-share transactions.³⁸ During the 1960's, the rapidly growing participation in the stock market by institutions and the concomitant increase in large block trading began to provide stock exchange member firms with commissions substantially in excess of the prices at which they would have been willing to execute the transactions in a competitive service market. Exchange rules prohibited member firms from reducing their rates to large customers or providing offsetting services,³⁹ but nothing prevented member firms from sharing their commissions with other member firms. Managers of certain large institutional investors, particularly the mutual funds, began to direct brokers to "give up" a portion of their commissions on fund portfolio transactions to other member firms.⁴⁰ These other member firms might be firms that had provided the fund with investment advice or, to an increasing extent, firms that had actively sold

³⁵ Wall St. J., June 10, 1969, at 4, col. 1.

³⁶ AMEX CONST. art. IV, § 1(c).

³⁷ *Id.* art. VI, § 2(b). The Pacific Coast Stock Exchange grants "preferred rates" (75% of the non-member minimum) to approved non-members who are members of a national securities exchange or national securities association, or who are engaged in the banking business. PCSE rule IV, § 2. A list of approved non-members is published by the Exchange.

³⁸ See note 11 *supra* and accompanying text.

³⁹ See notes 9 & 27 *supra*.

⁴⁰ The give-ups were usually at least 60%, and often 70% or more, of the commission received by the broker. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, published as H.R. REP. No. 2337, 89th Cong., 2d Sess. 170 (1966) [hereinafter cited as MUTUAL FUND REPORT].

the fund's shares.⁴¹ Initially the technique could be used only to compensate stock exchange member firms for sales of mutual fund shares, but, commencing in 1950, six of the seven regional exchanges amended their rules to permit members to "give up" part of their commissions to any member of the NASD. These amendments caused a substantial amount of business in dually-listed stocks to be diverted to the regional exchanges for the purpose of compensating non-member broker-dealers for mutual fund sales.⁴² The NYSE did not permit its members to split commissions with non-NYSE members on NYSE transactions,⁴³ but evidence introduced at the SEC hearing on stock exchange commission rates indicated that some member firms had channeled dollars to non-members by crediting them with arbitrary amounts on unrelated transactions in over-the-counter securities.⁴⁴

In 1965 two of the largest investment advisers, which distributed fund shares largely through their own organizations and therefore had no incentive to utilize brokerage commissions to reward dealers who sold fund shares, established broker-dealer subsidiaries that were admitted to membership on the Pacific Coast Stock Exchange (PCSE). These firms executed some transactions for the funds on the PCSE, but their principal purpose was to receive reciprocal business and give-ups from firms that executed transactions for the funds on other exchanges, principally the NYSE. All of the net profit from this operation, in one case, and approximately half of the net profit, in the other case, was returned to the funds in the form of reduction in the management fee paid to the adviser.⁴⁵

2. *The NYSE Proposal and the SEC Response*

In January 1968 the NYSE proposed to the SEC a five-point revision in its commission rate structure. The proposal envisioned unspecified volume discounts, continuation of customer-directed give-ups with a limitation on the percentage that might be given up, prohibition of "rebative" reciprocal practices, discounts for "qualified" non-member broker-dealers, and limitation of membership and discounts on all exchanges to "bona fide broker-dealers."⁴⁶ The SEC responded by inviting public comment on the NYSE proposals and on a proposed SEC rule that prohibited mutual fund managers from directing any give-up

⁴¹ *Id.* at 164-67.

⁴² *Id.* at 171.

⁴³ NYSE CONST. art. XV, § 8.

⁴⁴ See Washington Post, July 2, 1968, at D6, col. 1.

⁴⁵ MUTUAL FUND REPORT 109, 172.

⁴⁶ SEC Securities Exchange Act Release No. 8239 (Jan. 26, 1968).

of commissions on mutual fund portfolio transactions unless the benefits of the give-up accrued to the fund and its shareholders.⁴⁷

Among the comments received by the SEC was a lengthy memorandum from the Department of Justice, which concluded that "the maintaining of an effective auction market, does not appear to justify the fixing of minimum commission rates by the NYSE" and that "rate fixing is plainly unnecessary in institutional trading and, generally, for large transactions."⁴⁸ On May 28, 1968, the SEC requested the NYSE, pursuant to section 19(b) of the Exchange Act, to adopt as an interim measure either a specified revised commission rate schedule providing reduced rates for the portion of any order in excess of 400 shares or a rule eliminating minimum rates of commission on orders in excess of \$50,000.⁴⁹ At the same time, the SEC announced that it was ordering a general public investigatory hearing into the commission rate structure of the national securities exchanges.⁵⁰

On August 8, 1968, the NYSE proposed an alternative interim rate, providing reduced rates for that portion of any order in excess of 1,000 shares.⁵¹ On August 30 the SEC accepted the NYSE revision,⁵² which, after approval by the NYSE membership, went into effect on December 5, 1968.⁵³ The regional exchanges each adopted substantially identical rate structures. At the same time, each of the exchanges amended its constitution or rules to prohibit give-ups by providing that

[n]o member . . . shall, in consideration of the receipt of 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 . . . is or will be entitled.⁵⁴

3. *The Public Hearing on Commission Rates*

The SEC is continuing its public hearing into the commission rate structure. The principal alternatives under consideration for dealing with the problem of commission rates on large transactions are: (1) continuation of minimum commissions, either in the present or

⁴⁷ *Id.*

⁴⁸ Comments of the United States Dep't of Justice on SEC Securities Exchange Act Release No. 8239 (Jan. 26, 1968).

⁴⁹ SEC Securities Exchange Act Release No. 8324 (May 28, 1968).

⁵⁰ *Id.*

⁵¹ CCH Fed. Sec. L. Rep. ¶ 77,585 (1968).

⁵² SEC Securities Exchange Act Release No. 8399 (Sept. 4, 1968).

⁵³ For description of the revised rate schedule, see text accompanying notes 12-18 *supra*.

⁵⁴ See, e.g., NYSE CONST. art. XV, § 1; AMEX CONST. art. VI, § 1.

a modified form; (2) elimination of minimum commissions on large transactions; and (3) expanding large investors' opportunity to recapture a portion of their brokerage costs through membership on exchanges. The NYSE has consistently opposed eliminating minimum commissions on large transactions, on the ground that "[n]egotiated commission rates would minimize the incentive for members to conduct business primarily on the floor of the NYSE . . . [and] would divert trading into new and splintered over-the-counter markets."⁵⁵ The Justice Department and a number of economists, on the other hand, argue that fixing minimum rates in the securities industry is not only unnecessary,⁵⁶ but presents peculiar difficulties because of the great variations in size, efficiency, and product mix of brokerage firms.⁵⁷

The NYSE also opposes institutional membership,⁵⁸ which many brokers believe would deprive them of their best customers. Its announced reason is that "[g]ranted seats on the exchange, the institutions might soak up funds normally invested by individuals and sharply cut the small lot trading that provides the market's liquidity."⁵⁹ Managers of some investment institutions, on the other hand, believe they should be entitled to join exchanges, at least to the extent of enabling them to obtain the lower commission rates available to members.⁶⁰

The NYSE has announced that it hopes to submit a new rate schedule to the SEC early in 1970.⁶¹ In the meantime, however, the SEC has invited argument on the question whether, if minimum commission rates are to be retained, they should continue to fix an "all-inclusive" rate for non-members or should be limited to "such relatively standardized services as 'execution' and 'clearance,'" as in the case of intra-member rates.⁶²

⁵⁵ NYSE, *ECONOMIC EFFECTS OF NEGOTIATED COMMISSION RATES ON THE BROKERAGE INDUSTRY, THE MARKET FOR CORPORATE SECURITIES, AND THE INVESTING PUBLIC* 11 (1968).

⁵⁶ N.Y. Times, May 2, 1969, at 59, col. 1.

⁵⁷ Memorandum of the United States Dep't of Justice on the Fixed Minimum Commission Rate Structure 99-106 (Jan. 1969) [hereinafter cited as Justice Dep't Memo].

⁵⁸ N.Y. Times, Oct. 30, 1969, at 67, col. 1. See also *id.*, May 3, 1969, at 47, col. 8. The Justice Department's Antitrust Division has recently challenged the NYSE position that restrictions on public ownership of member firm shares should exist to prevent institutional investors from gaining membership on the exchange. Wall St. J., Nov. 18, 1969, at 3, col. 2.

⁵⁹ Wall St. J., Jan. 23, 1969, at 3, col. 2.

⁶⁰ See N.Y. Times, Nov. 17, 1969, at 73, col. 3.

⁶¹ NYSE Special Membership Bull., in BNA, SEC. REG. & L. REP., No. 26, at x-3 (Nov. 26, 1969).

⁶² SEC Securities Exchange Act Release No. 8791 (Dec. 31, 1969).

D. *Rates and Services to Small Customers*

The same rigid structure which makes large transactions highly profitable produces, at the other end of the scale, commissions on small transactions which many brokers assert are insufficient to cover the costs of handling them. There is no legal prohibition against charging more than the minimum commission rates on exchange transactions, but individual brokers are unwilling to do so.⁶³

Brokers and exchange officials have suggested modifications in the commission rate structure to deal with this problem, either increasing the minimum charge, or the "single transaction" charge, or imposing separate charges for the maintenance of an account or for specific services such as safeguarding customers' securities.⁶⁴ Pending such action, many brokerage houses have imposed minimum requirements for purchases by new customers. A survey by the NYSE in May 1969 showed that fourteen percent of the 514 firms responding required a new customer to make a minimum purchase ranging from \$1,500 to \$250,000; fifteen percent required a minimum purchase of \$1,000, and five percent had minimums ranging from \$100 to \$500.⁶⁵ No statute or exchange rule requires brokers to accept small customers, but exchange officials consider rejecting small accounts inconsistent with their policy of interesting small investors in the securities market.⁶⁶ The President of the NYSE has stated, however, that "one of the key changes in the commission structure [to be submitted to the SEC in early 1970] must be an increase in rates on small orders."⁶⁷

E. *Setting of Minimum Commission Rates*

1. *Action by the Exchanges*

Since trading on the NYSE accounts for the great majority of stock exchange commission business,⁶⁸ and since the membership of

⁶³ N.Y. Times, May 3, 1969, at 47, col. 8.

⁶⁴ Wall St. J., April 11, 1969, at 3, col. 2.

⁶⁵ Wall St. J., June 6, 1969, at 4, col. 4. More recently, several firms doing a large retail business have changed their method of compensating salesmen to make it less attractive for them to solicit small orders. See N.Y. Times, Dec. 15, 1969, at 77, col. 6; *id.* Dec. 16, 1969, at 67, col. 7.

⁶⁶ Ralph S. Saul, president of the AMEX, stated that a continuing rejection of smaller public transactions "could lead to further domination of the market by institutions—mutual funds, commercial banks, insurance companies and pension funds—with a corresponding loss of market liquidity." Wall St. J., April 11, 1969, at 3, col. 2.

⁶⁷ Address of Robert Haack, in BNA SEC. REG. & L. REP. No. 26, at x-1 (Nov. 26, 1969).

⁶⁸ See note 4 *supra* and accompanying text.

the NYSE overlaps that of the other exchanges to a large degree, the NYSE commission rate structure determines the pattern for the industry.

a. *Procedure.* The NYSE's basic commission rate structure is set forth in article XV of its constitution. Amendments to the constitution must be approved by a majority of the Board of Governors and by a majority of the members.⁶⁹ Since the product mix of NYSE members varies greatly from firm to firm, any change in the commission rate structure, other than an increase in the general level of rates, will be opposed by some group of members.⁷⁰ Each of the five changes in commission rates between 1934 and 1967 was recommended by a special committee of the NYSE and primarily involved an increase in the general level of rates, although limited structural changes were involved in some instances.⁷¹

b. *Standards.* The emphasis in the NYSE committee reports preceding the five rate increases was on the income received from commission business, the cost of doing such business, and the necessity for a "fair return."⁷² The NYSE's ability to develop precise standards has been hampered by the heterogeneity of the member firms, the absence of a mandatory uniform system of accounts, and limited capacity to gather economic information.⁷³

2. *Review by the SEC*

a. *Procedure.* Under section 19(b)(9) of the Exchange Act, the SEC is authorized to alter or supplement the rules of any exchange "in respect of . . . the fixing of reasonable rates of commission" if "after appropriate notice and opportunity for hearing, the Commission determines . . . that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange." Before altering or supplementing exchange rules, the SEC must first request the exchange to effect such changes itself.

The SEC has never exercised its authority under this section to

⁶⁹ NYSE CONST. art. XX. On the MSE and PCSE the Board of Governors has authority to set and change rates, and no amendment to the constitution or approval by the membership is necessary. PCSE CONST. art. XIV, § 1; MSE CONST. art. XII, § 2. The AMEX follows the NYSE pattern. AMEX CONST. art. XIII.

⁷⁰ See Wall St. J., Oct. 21, 1968, at 34, col. 1; *id.* Jan. 23, 1969, at 2, col. 3.

⁷¹ REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 95, 88th Cong., 1st Sess., pt. 2, at 329 (1963) [hereinafter cited as SPECIAL STUDY].

⁷² *Id.* at 333-37.

⁷³ *Id.* at 337-43.

alter or supplement exchange rules governing commission rates.⁷⁴ The 1968 change in commission rates for large orders⁷⁵ was the first change resulting from a formal request by the SEC under section 19(b)(9),⁷⁶ although rate increases put into effect by the NYSE in 1942 and 1958 were modified in accordance with "recommendations" or "suggestions" by the SEC.⁷⁷

Section 19(b) does not set forth any procedure for automatic SEC review of rule changes instituted by the exchange. In each of the four changes in commission rates between 1937 and 1953, the NYSE presented its proposals to the SEC and awaited the SEC's approval, or indication of lack of objection, before making any effort to put the rule changes into effect.⁷⁸ In 1958, however, the NYSE notified the SEC of proposed changes and eight days later submitted the proposed schedule to the membership for approval, without waiting for SEC reaction. The membership approved the rates, and they went into effect seven weeks after the notification to the SEC, despite the SEC's announcement of its intention to study their reasonableness.⁷⁹ The SEC completed its study several months later. The ensuing discussions resulted in the acceptance by the NYSE, in February 1959, of SEC suggestions to decrease certain commission rates at the lower range of the scale by approximately five percent and to eliminate the "round turn" discount adopted in 1953.⁸⁰

In light of the 1958 experience, the *Special Study* recommended that "existing procedures should be modified to assure that proposed changes in rates will be submitted to the Commission adequately in advance of their proposed effectiveness."⁸¹ Pursuant to this suggestion, the SEC in 1964 adopted rule 17a-8, requiring every exchange to file a report of any proposed rule change at least three weeks before any action is taken by the members or governing body of the exchange.⁸²

⁷⁴ The only case in which such authority has been exercised was *The Rules of the NYSE*, 10 S.E.C. 270 (1941), described in note 3 *supra*.

⁷⁵ See text accompanying notes 12-18 *supra*.

⁷⁶ SEC Securities Exchange Act Release No. 8324 (May 28, 1968).

⁷⁷ SPECIAL STUDY, pt. 2, at 330, 331, 344.

⁷⁸ *Id.* at 344.

⁷⁹ *Id.* at 345.

⁸⁰ *Id.* at 332.

⁸¹ *Id.* at 351.

⁸² The adoption of rule 17a-8 was proposed early in 1964. SEC Securities Exchange Act Release No. 7218 (Jan. 9, 1964). It became effective April 6, 1964. SEC Securities Exchange Act Release No. 7253 (March 3, 1964).

If any substantive change is made in the proposal, it starts a new three-week period.⁸³

b. *Standards.* Section 19(b) provides that the SEC may require such rule changes as "are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange." Section 19(b)(9) refers to the "fixing of *reasonable* rates of commission,"⁸⁴ but the *Special Study* noted the absence of any "comprehensive and consistent public articulation, on the part of the Exchange or the Commission, of the principles or criteria to be applied in interpreting the standard."⁸⁵ One can hope that the public hearing on the commission rate structure commenced in July 1968 will produce at least an attempt by the SEC to articulate these principles and criteria.

A related problem noted by the *Special Study* is the inadequacy of the data available to the SEC concerning the economics of the securities business.⁸⁶ Prior to 1968, the only information regularly available to the SEC was that voluntarily supplied by the NYSE on the basis of the income and expense reports submitted by its members. The *Special Study* found that despite improvements over the years, these reports failed to supply the data necessary to enable the SEC to discharge effectively its statutory obligation to review the "reasonableness" of commission rates.⁸⁷

In June 1968 the SEC adopted a new rule 17a-10, requiring every registered broker-dealer carrying public customer accounts to file an-

⁸³ The *Special Study* also recommended consideration of the feasibility of providing for a refund or adjustment of any portion of a rate increase which is put into effect by an exchange and subsequently disapproved by the SEC. SPECIAL STUDY, pt. 2, at 351. No specific action has yet been taken by the SEC to implement this proposal.

With respect to the possible liability of an exchange and its members under the antitrust laws for rates established by an exchange and subsequently disapproved by the SEC on the ground that they are not "reasonable," see *Sabre Shipping Corp. v. American President Lines, Ltd.*, 285 F. Supp. 949 (S.D.N.Y. 1968). In the *Sabre* case, involving the fixing of rates by a shipping conference, the court held, on a motion to dismiss, that the defendants enjoyed no immunity from antitrust laws notwithstanding a pending Federal Maritime Commission review of revised conference rates:

The mere fact that agreements setting rates are permitted to take effect prior to approval, does not mean that irrespective of their effect on the commerce of the United States they may be enjoyed until the defendants are caught, only to be released from all past liability simply by discontinuing those rates.

Id. at 955. See also text accompanying notes 90-112 *infra*.

⁸⁴ 15 U.S.C. § 78s(b)(9) (1964) (emphasis added).

⁸⁵ SPECIAL STUDY, pt. 2, at 343.

⁸⁶ *Id.* at 342.

⁸⁷ *Id.* at 342, 343.

nual income and expense reports with the SEC or with either the NASD or a national securities exchange, which will transmit the reports to the SEC.⁸⁸ A report must be made for each calendar year, starting with 1969, and is due ninety days after the end of the year. As a result of industry opposition to providing the SEC with specific information about individual firms, the rule provides that, in forwarding copies of the reports filed by their members to the SEC, the exchanges and the NASD may omit the names and addresses of the members for whom the reports are transmitted.

The rule requires the filing of one of three alternative forms. The most comprehensive form is to be filed by firms that are members of the NYSE or have gross securities income of \$1,000,000 or more during the year. An intermediate form is to be filed by non-members of the NYSE who have gross securities income between \$100,000 and \$1,000,000. The simplest form is to be filed by non-members of the NYSE who have gross securities income between \$20,000 and \$100,000 or have gross securities income of \$20,000 or more and derived more than eighty percent of such income from retail mutual fund sales, municipal bonds, fractional interests in oil, gas or other mineral rights, variable annuities, savings and loan placements, real estate syndications, or any combination of these. Firms that have gross securities income of less than \$20,000, that effect transactions only for other brokers or dealers, or that are engaged only in wholesale distribution of mutual fund shares or variable annuities are required to file only an introductory page containing very limited information. The new reports are designed "to provide needed comprehensive financial data on a continuing basis so that up-to-date information will be readily available to the SEC, the exchanges, and the NASD in connection with the performance of their respective responsibilities."⁸⁹

3. Antitrust Questions

The fixing of minimum commission rates by agreement among the members of an exchange would clearly violate section 1 of the Sherman Act as an agreement among competitors to restrain price competition, unless an exemption is available. In *Silver v. New York Stock Exchange*,⁹⁰ decided in 1963, the Supreme Court held that

The Securities Exchange Act contains no express exemption from the antitrust laws This means that any repealer of the

⁸⁸ Proposed, SEC Securities Exchange Act Release No. 8242 (Feb. 1, 1968); adopted, SEC Securities Exchange Act Release No. 8347 (June 28, 1968).

⁸⁹ *Id.*

⁹⁰ 373 U.S. 341 (1963).

antitrust laws must be discerned as a matter of implication, and "[i]t is a cardinal principle of construction that repeals by implication are not favored." . . . Repeal 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.⁹¹

The *Silver* case did not involve the NYSE's power to adopt rules fixing minimum rates of commissions, but rather its action in instructing its members to discontinue their wire connections with the plaintiff, a non-member firm.

In *Kaplan v. Lehman Brothers*⁹² shareholders in five mutual funds sued the NYSE and four of its member firms, which had acted as brokers for the funds, to recover treble damages based on the difference between the commissions charged to the funds under the NYSE rules and the rates that would have been available to the funds "by the operation of free and open competition."⁹³ Plaintiffs took the position that prescribed minimum rates can never be reasonable and that the fixing of minimum rates through the collective action of NYSE members is therefore illegal per se under the Sherman Act.⁹⁴ On the issue of per se illegality, the district court held that if the NYSE action was within the authority conferred on the Exchange by the 1934 Act, plaintiffs' position was inconsistent with the *Silver* decision. The court entered summary judgment for defendants. On appeal to the Seventh Circuit, the SEC filed an amicus curiae brief⁹⁵ that urged three points: (1) "Collective action by the Exchange and its members in establishing commission rate rules is specifically contemplated under the Securities Exchange Act and thus does not constitute a per se violation of the antitrust laws;"⁹⁶ (2) the possible unreasonableness of existing minimum commission rates should not give rise to a cause of action under the antitrust laws;⁹⁷ and (3) an exchange should be exempt from antitrust liability when

- (1) the allegedly illegal conduct is strictly pursuant to an exchange rule promulgated in the course of self-regulatory duties and consistent with traditional concepts of fair and orderly procedures;
- (2) the exchange rule was filed with Commission; (3) the particular

⁹¹ *Id.* at 357.

⁹² 250 F. Supp. 562 (N.D. Ill. 1966), *aff'd*, 371 F.2d 409 (7th Cir.), *cert. denied*, 389 U.S. 954 (1967).

⁹³ 250 F. Supp. at 563.

⁹⁴ *Id.* at 564.

⁹⁵ Brief for Securities & Exchange Commission as Amicus Curiae, *Kaplan v. Lehman Bros.*, 371 F.2d 409 (7th Cir. 1967).

⁹⁶ *Id.* at 11.

⁹⁷ *Id.* at 20.

rule in question was subject to the Commission's oversight and authority under Section 19(b) or other sections of the Exchange Act, and within the area in which Congress contemplated that the exchanges would act, unless and until otherwise determined by the Commission; and (4) the rule is applied in a fundamentally fair manner consistent with the purposes and goals of the Exchange Act.⁹⁸

The court of appeals affirmed in a two-page opinion which went beyond the position taken by either the district court or the SEC. It "interpreted" the district court's action "as holding that the antitrust laws are inapplicable to the New York Stock Exchange insofar as its prescribing of minimum commission rates is concerned," and held that

[o]n the facts set forth in the complaint herein, we do not construe the Sherman act and the exchange act as showing a congressional intention to permit the maintenance of an antitrust prosecution of the exchange or its members to be based upon its action relating to rates of commission to be charged by its members.⁹⁹

The Supreme Court denied certiorari, over the dissent of Chief Justice Warren who argued that the "blunderbuss approach" of the Seventh Circuit "falls far short of the close analysis and delicate weighing process mandated by this Court's opinion in *Silver*."¹⁰⁰

On July 1, 1968, the SEC commenced a public hearing into the commission rate structure of the national securities exchanges.¹⁰¹ The memorandum that the NYSE submitted in August 1968¹⁰² argues, on the basis of legislative history, not only that the antitrust laws are inapplicable to the fixing of minimum commission rates by exchanges, but that the SEC has no power under the Exchange Act "to prevent the exchanges from fixing commission rates or to abolish exchange rules which do so."¹⁰³ The NYSE further contends that elimination

⁹⁸ *Id.* at 32-33 (footnote omitted).

⁹⁹ 371 F.2d at 411. *Cf.* *Thill Securities Corp. v. New York Stock Exchange*, 38 U.S.L.W. 2138 (E.D. Wis. Aug. 21, 1969), where the court held that the NYSE prohibition against members sharing commissions with non-members did not constitute a per se violation of the antitrust laws and that it would be inappropriate for the court to inquire into the reasonableness of the prohibition in light of the SEC's current hearings on stock exchange commission rates.

¹⁰⁰ 389 U.S. 954, 957 (1967) (dissenting opinion). Neither the SEC nor the Justice Department took a position on the granting of certiorari.

¹⁰¹ See SEC Securities Exchange Act Release No. 8324 (May 28, 1968).

¹⁰² Memorandum on Behalf of the New York Stock Exchange on Commission Rate Structure of Registered National Securities Exchanges, August 1968.

¹⁰³ *Id.* at 7. *But see* SEC Securities Exchange Act Release No. 8324 (May 28, 1968), requesting the NYSE, pursuant to § 19(b) of the Exchange Act, either to adopt specified revised minimum commission rates or to eliminate minimum rates with respect to orders

of fixed minimum commissions would "undermine" the regulatory role of exchanges,¹⁰⁴ "result in destructive competition,"¹⁰⁵ and "result in rate discriminations, unrelated to volume discounts or cost savings, in favor of large investors."¹⁰⁶

The Justice Department responded in January 1969 with a 200-page memorandum.¹⁰⁷ It contends that "the system of fixed minimum commissions is not justified or needed 'to make the Securities Exchange Act work,'"¹⁰⁸ and that the "historical context is utterly inconsistent with any inference that Congress intended to ratify the then existing rate structure or other practices."¹⁰⁹ The memorandum concludes that the SEC "has the duty to effect the reconciliation of the antitrust laws and the Securities Exchange Act outlined in the *Silver* case," and "has the power, and indeed the duty, to abolish commission rate fixing on registered national securities exchanges except to the extent that it can be shown that such price fixing is necessary to achieve the purposes of the Act."¹¹⁰ The Justice Department also argues that elimination of fixed minimum commission rates would "strengthen the NYSE mar-

above \$50,000. In its reply, the NYSE indicated that it considered both alternatives, but felt that it was in the public interest to maintain minimum rates of commission. Letter from NYSE to SEC, Aug. 8, 1968.

¹⁰⁴ NYSE Memorandum, *supra* note 102, at 18.

¹⁰⁵ *Id.* at 20.

¹⁰⁶ *Id.* at 24.

¹⁰⁷ Justice Dep't Memo, *supra* note 57.

¹⁰⁸ *Id.* at 13.

¹⁰⁹ *Id.* at 21.

¹¹⁰ *Id.* at 18. See *FMC v. Aktiebolaget Svenska Amerika Linien*, 390 U.S. 238 (1968), involving shipping conference rules that prohibited travel agents from selling passage across the Atlantic on non-conference lines and required unanimous action by conference members before the maximum commission rates payable to travel agents could be changed. The Federal Maritime Commission, in disapproving the agreements as "contrary to the public interest," stated that "conference restraints that interfere with the policies of antitrust laws will be approved only if . . . necessary to secure important public benefits or in furtherance of a valid regulatory purpose of the Shipping Act." It placed the burden of proof on the steamship lines to establish these legitimate objectives and justify the restraints. The steamship lines argued that the FMC antitrust test was not a permissible elaboration of the "public interest" standard since "the whole purpose of the statutory scheme would be defeated if incompatibility with the antitrust laws can be a sufficient reason for denying immunity from these laws." The Supreme Court unanimously affirmed the FMC's decision, holding that

once an antitrust violation is established, this alone will normally constitute substantial evidence that the agreement is "contrary to the public interest," unless other evidence in the record fairly detracts from the weight of this factor. . . . [Thus] the antitrust test formulated by the Commission is an appropriate refinement of the statutory "public interest" standard.

Id. at 245-46. See Note, *Antitrust and the Securities Industry: Lessons from the Shipping Industry*, 55 CORNELL L. REV. 96 (1969).

ket,"¹¹¹ and recommends that the SEC eliminate fixed minimum commission rates over a five-year period, commencing with the elimination of fixed minimums on transactions over \$50,000 and reducing that figure by \$10,000 each year.¹¹²

III

OVER-THE-COUNTER TRANSACTIONS

In contrast to stock exchange transactions, no minimum commission rates are applicable to transactions in the over-the-counter (OTC) market. The Exchange Act specifically provides that a national securities association, such as the NASD, may not adopt rules designed "to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges." On the other hand, the rules of such an association must be designed "to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges."¹¹³

The rules governing compensation for transactions in the OTC market are complicated by the broker-dealer's ability, in many transactions, to choose whether to act as agent or principal. If the broker-dealer maintains an inventory in the particular security, he will normally sell to his customer from that inventory as principal. If he must obtain the security from another dealer, he may either buy for his customer as agent and charge a commission or buy as principal and resell to the customer at a mark-up.

An SEC sampling of sales of 135 OTC stocks on January 18, 1962, showed that in fifty percent of the retail sales transactions the broker-dealers purchased for customers as agents, in twenty-five percent they purchased and resold as principal, and in twenty-five percent they sold as principal from inventory.¹¹⁴ An NASD sampling of 246 stocks sold on August 11, 1965, showed that in sixty-six percent of such transactions the broker-dealers purchased for customers as agents, in twelve

¹¹¹ Justice Dep't Memo 43.

¹¹² *Id.* at 195, 196. The present Assistant Attorney General, Richard W. MacLaren, has taken a similar position, stating that "[t]he question is whether rate fixing and related practices are necessary . . . to achieve a legitimate goal of the Exchange Act. . . . If they are not necessary, then they are subject to the Sherman Act, just like any other agreement in restraint of trade." BNA SEC. REG. & L. REP. No. 5, at A-2 (July 2, 1969).

¹¹³ Securities Exchange Act of 1934, § 15A(b)(8), 15 U.S.C. § 78o-3(b)(8) (1964).

¹¹⁴ OTC STUDY 15.

percent they purchased and resold as principal, and in twenty-two percent they sold as principal from inventory.¹¹⁵

A. *Compensation for Acting as Customer's Agent*

When a broker-dealer buys or sells a security for a customer as agent, the NASD requires that

he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor.¹¹⁶

The amount of the commission must be set forth on the confirmation that the broker-dealer is required to send the customer on completion of the transaction.¹¹⁷

Although stock exchange commission rate schedules are inapplicable to OTC stock transactions, including transactions handled by member firms, the *Special Study* found that approximately ninety-five percent of the agency transactions in OTC stocks in its 1962 sample were executed at the NYSE commission rate, and that non-member as well as member firms tended to use the NYSE schedule in such transactions.¹¹⁸ A study of agency transactions done for the NASD showed that the average charge on a purchase or sale for a customer in September 1965 was 1.10 percent of the money involved in the transaction.¹¹⁹

B. *Compensation for Dealing with Customer as Principal*

In contrast to the situation where a broker-dealer acts as agent for his customer, a broker-dealer who acts as a principal in the sale of a security to his customer is not required to disclose on the confirmation anything other than the "net" price to be paid by the customer for the security.¹²⁰ Without information as to the cost of the security to the dealer or the prices currently being quoted by dealers

¹¹⁵ *Id.* The reasons for the increase in agency transactions as against non-inventory principal transactions are discussed in text accompanying notes 147-160 *infra*.

¹¹⁶ NASD Rules, art. III, § 4.

¹¹⁷ Securities Exchange Act of 1934, § 15(c)(1); rule 15c1-4, 17 C.F.R. § 240.15c1-4 (1969).

¹¹⁸ SPECIAL STUDY, pt. 2, at 624, 625.

¹¹⁹ OTC STUDY 34.

¹²⁰ See Securities Exchange Act of 1934, § 15(c)(1); rule 15c1-5.

making a market in the stock, the customer has no way of knowing what he is being charged for the dealer's services.¹²¹

1. *Limitations on Mark-Ups*

In 1942 the SEC published for comment a rule that would have required dealers to disclose to their customers in principal transactions the best current independent bid and asked prices for the security. The NASD opposed this proposal, and surveyed its members to determine their mark-up practices. It ascertained that forty-seven percent of the transactions were made at mark-ups of three percent or less and seventy-one percent were made at mark-ups of five percent or less.¹²² In October 1943 the NASD distributed the results of the survey to its members, noting that there might be circumstances in which a mark-up of more than five percent would be justified, and that a mark-up of five percent or even lower is not always justified, but the five percent figure would serve as a guide to what constitutes a "fair spread or profit" within the meaning of the NASD's Rules of Fair Practice.¹²³

This "five percent policy" has been elaborated through interpretation over the years. The amount of the mark-up is to be computed by reference to the "prevailing market price," of which the dealer's contemporaneous cost is the best indication in the absence of other bona fide evidence.¹²⁴ A mark-up pattern of five percent or even less may be considered unfair or unreasonable under appropriate circumstances. The fairness of mark-ups may not be justified on the basis of excessive expenses, but should be determined by reference to all relevant factors, including the type and price of the security and its availability in the market, the amount of money involved in the transaction, the nature of the dealer's business, the type of service and facilities provided to customers, the dealer's general pattern of mark-ups, and the type and extent of disclosure he makes to his customers.¹²⁵

A large number of disciplinary proceedings based wholly or partly on excessive mark-ups have been brought against broker-dealers by both the NASD and the SEC. Both the NASD and the SEC require

¹²¹ See *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943).

¹²² NASD Rules, Interpretation of the Board of Governors following article III, § 4.

¹²³ *Id.* In 1944, members of the NASD challenged the Board's authority to establish the "5% policy" by interpretation of the Rules of Fair Practice and demanded that the policy statement be considered a rule which must be submitted to a membership vote. The SEC held that the Board's action was "by no means an inflexible limitation on spreads," and thus constituted an interpretation rather than a rule. *NASD, Inc.*, 17 S.E.C. 459 (1944).

¹²⁴ NASD Rules, Interpretation of the Board of Governors following article III, § 4.

¹²⁵ *Id.*

that retail sales and purchase prices be reasonably related to the "current" or "prevailing" market price at the time of the challenged transactions.¹²⁶ Usually proceedings are initiated against brokers whose mark-ups are consistently not reasonably related to current market price. Objectionable patterns have consisted of as many as 563¹²⁷ and as few as fourteen¹²⁸ transactions, and mark-ups found unfair have ranged from 5.4 percent¹²⁹ to 200 percent.¹³⁰ Although the decisions generally refer to the NASD's "five percent policy," mark-ups between five percent and ten percent may be justified in some instances. Mark-ups above ten percent are generally considered unjustifiable.¹³¹ In cases that also involve other improper practices, a violation of the mark-up rule may be found on the basis of fewer transactions and lower mark-ups.¹³²

When the NASD has shown the existence of a pattern of mark-up violations, the member has the burden of establishing "justifying circumstances" for his action.¹³³ The following have been held not to be "justifying circumstances": excessive expenses in making a sale;¹³⁴ risk in maintaining a large inventory;¹³⁵ small total dollar amount of the transaction;¹³⁶ reliance on NASD inspection and approval of books;¹³⁷ and mark-ups consistent with those customary in the vicinity.¹³⁸ In

¹²⁶ Thill Securities Corp., SEC Securities Exchange Act Release No. 7342, at 6 (June 11, 1964).

¹²⁷ J.A. Winston & Co., SEC Securities Exchange Act Release No. 7334 (June 5, 1964).

¹²⁸ Powell & McGowan, Inc., SEC Securities Exchange Act Release No. 7302 (April 24, 1964).

¹²⁹ *Id.*

¹³⁰ Linder, Bilotti & Co., Inc., SEC Securities Exchange Act Release No. 7738 (Nov. 5, 1965).

¹³¹ Gateway Stock & Bond, Inc., SEC Securities Exchange Act Release No. 8003, at 4 (Dec. 8, 1966). The SEC has "repeatedly held that mark-ups of more than 10% are unfair even in the sale of low priced securities and particularly where there are transactions of substantial size." Costello, Russotto & Co., SEC Securities Exchange Act Release No. 7729, at 5 (Oct. 22, 1965).

¹³² Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965); Powell & McGowan, Inc., SEC Securities Exchange Act Release No. 7302 (April 24, 1964).

¹³³ NASD Rules, Interpretation of the Board of Governors following article III, § 4.

¹³⁴ Kenneth B. Stucker Investment Securities, SEC Securities Exchange Act Release No. 7823 (Feb. 15, 1966).

¹³⁵ General Investing Corp., SEC Securities Exchange Act Release No. 7316 (May 15, 1964).

¹³⁶ Amsbary, Allen & Morton, Inc., SEC Securities Exchange Act Release No. 7834 (March 7, 1966).

¹³⁷ Midland Securities, Inc., 40 S.E.C. 333 (1960).

¹³⁸ Amsbary, Allen & Morton, Inc., SEC Securities Exchange Act Release No. 7834 (March 7, 1966).

many instances, the dealer claims his mark-up was justified because the sale was of a low-priced security, relying on an NASD statement that a "somewhat higher percentage may sometimes be justified" in the case of a low-priced security; *i.e.*, a security that sells for ten dollars or less.¹³⁹ It seems, however, that the "low price factor" alone will not justify a consistent pattern of mark-ups at a level substantially above five percent.¹⁴⁰

a. *Determination of Prevailing Market Price.* A retail dealer who does not maintain a position in a particular security should, in the absence of countervailing evidence, use his contemporaneous cost—the price paid to other dealers to purchase the same security on the same day—as his mark-up base.¹⁴¹

When a dealer who makes a wholesale market in a security sells that security to a retail customer out of inventory, there is a question whether the mark-up should be based on the dealer's contemporaneous cost, normally his *bid* price, or the price at which the stock is then being *offered* by dealers to one another. The *Special Study* found that most integrated firms base their mark-up on the price at which they are then offering the stock to other dealers¹⁴² and recommended that the obligations of an integrated broker-dealer in respect to his retail pricing be "defined . . . more clearly and positively."¹⁴³ The 1966 *OTC Study*¹⁴⁴ computed gross income from retail OTC sales as "the difference between the then current interdealer *asked* price and the 'net' price confirmed to the customer."¹⁴⁵

Recent cases indicate that an integrated dealer is required to use his contemporaneous cost as a mark-up base when the security is not actively-traded among dealers, that is, when no independent competi-

¹³⁹ *Handley Invest. Co. v. SEC*, 354 F.2d 64, 65 (10th Cir. 1965) (quotes interpretation of NASD Rules art. III, §§ 1, 4, which refer to securities worth less than \$10); *Samuel B. Franklin & Co. v. SEC*, 290 F.2d 719, 725 (9th Cir. 1961) (court refers to the same quote); *Ross Securities Inc.*, 40 S.E.C. 1064, 1066 (1962).

¹⁴⁰ *See Handley Invest. Co. v. SEC*, 354 F.2d 64 (10th Cir. 1965) (25%-57% mark-up on 6¾-8½ cent stocks held excessive); *Managed Investment Programs*, 37 S.E.C. 783 (1957) (10%-21% mark-up on \$2 and \$3 stocks held excessive); *Amsbary, Allen & Morton, Inc.*, SEC Securities Exchange Act Release No. 7834 (March 7, 1966) (8.3%-11% on 26 transactions at prices from \$5.75-\$6.50 held excessive).

¹⁴¹ *See Kenneth B. Stucker Investment Securities*, SEC Securities Exchange Act Release No. 7823 (Feb. 15, 1966); *Costello, Russotto & Co.*, SEC Securities Exchange Act Release No. 7729, at 2 (Oct. 22, 1965); *J.A. Winston & Co.*, SEC Securities Exchange Act Release No. 7337 (June 8, 1964).

¹⁴² *SPECIAL STUDY*, pt. 2, at 649.

¹⁴³ *Id.* at 677.

¹⁴⁴ *See* note 1 *supra*.

¹⁴⁵ *OTC STUDY*, Appendix C, form III.

tive market exists. This is usually the case where the integrated firm is the dominant factor in either the wholesale or retail market. When an independent competitive retail and wholesale market does exist, the integrated dealer may use the offering prices quoted by other dealers to one another as the basis for his retail mark-ups.¹⁴⁶

2. *Special Study Recommendations*

Among the sixteen recommendations of the *Special Study* concerning OTC markets, three recommendations relating to dealers' charges for retail transactions were subjects of particular objection by segments of the securities business.¹⁴⁷

a. "*Riskless*" Transactions. The *Special Study* recommended that "a broker-dealer who neither is a primary market maker nor has a bona fide inventory position should be required (subject to defined exceptions) to execute customers' orders on an agency basis."¹⁴⁸ This proposal was designed to require disclosure of the amount of the retail mark-up in the so-called "riskless transaction" whereby a broker-dealer, after accepting a customer's order, purchases the stock from another dealer as principal and resells at a mark-up to the customer.

In discussions with the SEC in 1964, the NASD argued that this proposal would tend to force firms to execute OTC transactions at commissions roughly equivalent to NYSE minimum commission rates, thus putting an "economic squeeze" on its members and diverting their merchandising efforts away from OTC stocks.¹⁴⁹ The SEC has taken no action to implement the recommendation. The 1966 *OTC Study* showed, however, that the average mark-up on "riskless" principal transactions declined from 2.93 percent in September 1963 to 2.40 percent in September 1965, while, in comparison, average commissions on agency transactions only declined from 1.13 percent to 1.10 percent during the same period.¹⁵⁰ Furthermore, between 1962 and 1965 the proportion of retail OTC sales accounted for by "riskless" principal transactions declined from about twenty-five percent to about twelve percent, while the proportion accounted for by agency transactions in-

¹⁴⁶ Langley-Howard, Inc., SEC Securities Exchange Act Release No. 8361 (July 21, 1968); Century Securities Co., SEC Securities Exchange Act Release No. 8123 (July 14, 1967); Gateway Stock & Bond, Inc., SEC Securities Exchange Act Release No. 8003 (Dec. 8, 1966); Strathmore Securities, Inc., SEC Securities Exchange Act Release No. 7864 (April 18, 1966); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965).

¹⁴⁷ OTC STUDY 1.

¹⁴⁸ SPECIAL STUDY, pt. 2, at 676.

¹⁴⁹ OTC STUDY 2.

¹⁵⁰ *Id.* at 34.

creased from about fifty percent to sixty-six percent.¹⁵¹ These changes are attributable in part to the improvements in disclosure discussed below.¹⁵²

b. *Disclosure.* The *Special Study* recommended changes in the manner in which "retail" quotations were furnished either by or under the supervision of the NASD for publication in newspapers.¹⁵³ While the bid prices published at that time generally represented the inter-dealer bids, the retail asked prices were generally determined by adding to the inter-dealer asked prices a percentage mark-up ranging from about five percent on stocks selling below twenty-five dollars to about two percent on stocks selling above \$135.¹⁵⁴ The *Special Study* concluded that this system must be "confusing if not deceptive to many investors"¹⁵⁵ since an investor "may get the impression or actually be told that his security was bought commission free, below the 'high.'"¹⁵⁶ It recommended that the newspaper quotations be revised "to show generally . . . the best prevailing interdealer bid and asked quotations that can be reasonably ascertained."¹⁵⁷

In 1964 the NASD, with the concurrence of the SEC, adopted a plan providing for newspaper publication of representative inter-dealer bid and asked prices for the approximately 1,300 actively traded stocks of larger companies that appear on the "national list." This system was inaugurated "on a test basis" in February 1965, and has been in effect since that time. In 1966 it was extended to the less actively traded securities of smaller companies appearing on the so-called "local lists."¹⁵⁸

A third controversial recommendation by the *Special Study* was that a broker-dealer selling as principal be required to state in the confirmation the inter-dealer price available at the time of the transaction, thereby showing the customer the approximate amount of the mark-up.¹⁵⁹ The NASD strongly opposed this recommendation on economic grounds,¹⁶⁰ and it has not been implemented.

¹⁵¹ *Id.* at 15.

¹⁵² *Id.*

¹⁵³ SPECIAL STUDY, pt. 2, at 677.

¹⁵⁴ *Id.* at 634.

¹⁵⁵ *Id.* at 667.

¹⁵⁶ *Id.* at 644 (footnote omitted).

¹⁵⁷ *Id.* at 677.

¹⁵⁸ NASD, 1966 ANN. REP. 4.

¹⁵⁹ SPECIAL STUDY, pt. 2, at 677, 678.

¹⁶⁰ OTC STUDY 2.

IV

SALE OF MUTUAL FUND SHARES

A. *Method of Fixing Sales Loads*

In contrast to stock exchange transactions, for which uniform minimum commissions are established by the various exchanges, and to OTC transactions, to which no minimum commissions or mark-ups are applicable, the compensation payable to a dealer for selling shares of a mutual fund is fixed by the sponsor of each fund and is binding on all dealers who sell shares of that fund.

Under section 22(d) of the Investment Company Act of 1940, no dealer may sell shares of a mutual fund to a public customer "except at a current public offering price described in the prospectus." This restriction is applicable regardless of whether the dealer acquired the shares from the fund itself or from a shareholder of the fund.¹⁶¹ The fund prospectus normally sets forth the public offering price of fund shares in terms of the net asset value of the fund on a per-share basis plus a sales load, which is a specified percentage of the public offering price.¹⁶² For example, if a mutual fund prospectus specifies a sales load of 8.5 percent of the public offering price, and the current net asset value of the fund works out to \$9.15 per share, a customer who buys one hundred shares of the fund will pay \$1,000, of which \$85 (8.5 percent of the *public offering price*) is divided between the dealer and the principal underwriter and \$915 is paid over to the fund to purchase the one hundred shares.

B. *Level of Sales Loads*

In its 1966 *Mutual Fund Report*, the SEC found that the prevailing level of sales loads was 8.5 percent of the public offering price.¹⁶³

¹⁶¹ This restriction was a factor in the virtual elimination of secondary trading in mutual fund shares.

¹⁶² Rule 22c-1, which became effective January 13, 1969, provides that the price at which mutual fund shares are sold must be based on the first net asset value computed after the order is received by the dealer. This procedure is known as "forward pricing." The net asset value must be recomputed at least once a day. Prior to January 13, 1969, many funds sold shares on the basis of the last net asset value computed before a specified cut-off time which preceded the receipt of the order. Rule 22c-1: *proposed*, SEC Investment Company Act Release No. 5413 (June 25, 1968); *adopted*, SEC Investment Company Act Release No. 5519 (Oct. 16, 1968); *interpreted*, SEC Investment Company Act Release No. 5569 (Dec. 27, 1968).

¹⁶³ SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, *published as*

Of the 195 load funds listed in one compilation, none charged more than nine percent, 102 charged exactly 8.5 percent, and only eight charged less than 7.5 percent.¹⁶⁴ The Commission also found that competitive pressures had resulted in an increase in sales loads over the years, since funds compete for the favor of dealers by offering higher compensation rather than for the favor of customers by offering lower sales costs.¹⁶⁵ A survey of thirty leading load funds indicated that the median sales load had increased from 7.5 percent in 1950 to 8.5 percent in 1966.¹⁶⁶

There is no general statutory limit on mutual fund sales charges. Section 27(a)(1) of the Investment Company Act, however, limits the sales load on periodic payment plans to nine percent,¹⁶⁷ and there have been some indications that the SEC might take the view that a sales load in excess of nine percent on shares of any mutual fund is "unconscionable or grossly excessive."¹⁶⁸

Section 22(b) of the Investment Company Act authorizes the NASD to adopt rules limiting the discount from the public offering price at which its members may purchase mutual fund shares "in order that the price at which such security is offered or sold to the public shall not include an unconscionable or grossly excessive sales load."¹⁶⁹ Pursuant to this provision, the NASD has adopted a rule prohibiting any member from participating in the offering or sale of mutual fund shares for which they act as underwriter, if the offering price includes a sales load "which is unfair, taking into consideration all relevant circumstances, including the current marketability of such security and all expenses involved."¹⁷⁰

However, the NASD has specifically made its "five percent policy" on mark-ups for OTC securities inapplicable to the distribution of mutual fund shares on the ground that such transactions are "underwriting" activities.¹⁷¹ This rationale is questionable; distribution of mutual fund shares is technically an "underwriting" activity in the sense of a public offering of newly issued securities, but it is com-

H.R. REP. NO. 2337, 89th Cong., 2d Sess. 19 (1966) [hereinafter cited as MUTUAL FUND REPORT].

¹⁶⁴ *Id.* at 204.

¹⁶⁵ *Id.* at 208.

¹⁶⁶ *Id.*

¹⁶⁷ See text accompanying notes 193-94 *infra*.

¹⁶⁸ *Hearings on H.R. 9510 & 9511 Before the Subcomm. of the House Comm. on Interstate and Foreign Comm.*, 90th Cong., 1st Sess. 722 (1967).

¹⁶⁹ 15 U.S.C. § 80a-22(b) (1964).

¹⁷⁰ NASD Rules, art. III, § 26(d).

¹⁷¹ NASD Rules, Interpretation of the Board of Governors following article III, § 4.

pletely "riskless" since NASD rules prohibit members from purchasing any shares of a mutual fund except for the purpose of filling an order already received from a customer.¹⁷²

In its 1966 *Mutual Fund Report*, the SEC recommended that the Investment Company Act be amended to provide that sales charges for mutual fund shares be limited to five percent of the net asset value (equivalent to 4.76 percent of the public offering price).¹⁷³ This proposal was strongly opposed by the industry, and the Senate Banking and Currency Committee rejected it during the 1967 hearings on mutual fund legislation. The Committee instead recommended an amendment of section 22(b) to authorize the NASD (or any other securities association registered under section 15A of the Exchange Act) to prohibit its members from offering mutual fund shares at a price that includes an "excessive" sales load.¹⁷⁴ This provision was carried over into the 1969 Senate bill.¹⁷⁵ In formulating rules as to excessive sales loads, the association would be required by the bill to "allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors."¹⁷⁶

Eighteen months after enactment of the proposed amendments, the SEC would be authorized to alter or supplement the rules of the association as necessary to effectuate the purpose of the amendments.¹⁷⁷ This authority would be exercised in the manner prescribed in section 15A(k)(2) of the Exchange Act, under which the SEC must first request the association to alter or supplement its rules in a specified manner. If such action is not taken within a reasonable time, the SEC itself, after appropriate notice and opportunity for hearing, may order the rules of the association to be altered or supplemented as necessary to effectuate the statutory objectives.¹⁷⁸

The SEC would also be authorized, after eighteen months, to adopt rules effectuating the purpose of the amendments by regulating sales by broker-dealers who are not members of a registered securities

¹⁷² NASD Rules, art. III, § 26(f)(2).

¹⁷³ MUTUAL FUND REPORT 223.

¹⁷⁴ S. REP. NO. 1351, 90th Cong., 2d Sess. 2, 15 (1968) [hereinafter cited as *1968 Senate Report*]. At present such an association can prohibit only sales at prices that include "unconscionable or grossly excessive" sales loads. Investment Company Act of 1940, § 22(b), 15 U.S.C. § 80a-22(b) (1964).

¹⁷⁵ S. 2224, 91st Cong., 1st Sess. § 12 (1969). The Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce held hearings on the Senate bill in late 1969. This provision of the bill is not opposed by the industry.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Cf.* note 74 *supra* and accompanying text.

association.¹⁷⁹ However, a non-member broker-dealer would not be subject to regulation if the underwriter of the mutual fund shares which he is selling filed a notice of election to comply with the rules of the association in distributing the shares of such fund.¹⁸⁰

C. *Quantity Discounts*

The public offering price set forth in a mutual fund prospectus customarily provides for progressively lower sales loads on larger purchases. The first breakpoint is usually between \$10,000 and \$25,000; above it the sales load is about one percent lower. There are usually further step-downs leading ultimately to a load of about one percent on sales exceeding \$1,000,000.¹⁸¹ Many funds permit a series of purchases, or purchases of shares of different funds distributed by the same principal underwriter, to be cumulated for purposes of entitling the purchaser to the lower sales load.¹⁸²

In 1941 the SEC's General Counsel gave an opinion that the quantity discount practice did not violate section 22(d), which requires that mutual fund shares be sold at "a current public offering price described in the prospectus," if the quantity discounts were clearly described in the prospectus and available to any member of the public on a nondiscriminatory basis.¹⁸³ In 1958 the SEC codified this opinion in rule 22d-1,¹⁸⁴ which provides an exemption from section 22(d) to the extent necessary to permit sales at reduced sales loads "in accordance with a scale of reducing sales load varying with the quantity of securities purchased by any person." The rule provides that the reduced sales load may be applied to the purchase of shares of several funds distributed by the same principal underwriter. The reduction may be applied on the basis of the amount involved in (1) a single purchase, (2) a single purchase plus amounts previously purchased, or (3) a series of purchases over a period of not less than thirteen months pursuant to a "statement of intention" containing certain specified provisions.

In a recent case based on the contention that mutual fund quantity

¹⁷⁹ Several large mutual fund underwriters distribute their shares through "captive" sales organizations which are not members of the NASD.

¹⁸⁰ S. 2224, 91st Cong., 1st Sess. § 12 (1969).

¹⁸¹ MUTUAL FUND REPORT 210. Inducing a customer to purchase an amount of shares just below an amount that would entitle him to a lower sales load has been held by the NASD to be contrary to just and equitable principles of trade. NASD MANUAL, Interpretation of Board of Governors ¶ 5266. See Mason, Moran & Co., 35 S.E.C. 84 (1953); SEC Securities Exchange Act Release No. 7743, at 34 (Nov. 12, 1965); Russell L. Irish Investments, SEC Securities Exchange Act Release No. 7687, at 7 (Aug. 27, 1965).

¹⁸² MUTUAL FUND REPORT 206, 207.

¹⁸³ Opinion of General Counsel, SEC Investment Company Act Release No. 89 (March 13, 1941); 2 P-H SEC. REG. ¶ 26,324.1, at 25,656.

¹⁸⁴ SEC Investment Company Act Release No. 2798, at 47 (Dec. 2, 1958).

discounts violate the price discrimination provisions of the Robinson-Patman Act,¹⁸⁵ the court concluded that

[T]he Act was enacted to protect only persons in a competitive relationship with one another, and personal investors do not occupy that status. The alleged "price discrimination" would be immune from attack . . . because cumulative quantity discounts are impliedly exempted from the Robinson-Patman Act by virtue of the Investment Company Act of 1940 and the rules and regulations of the SEC enacted pursuant to it.¹⁸⁶

1. Group Sales

Prior to 1958, the SEC allowed medical and dental associations and other groups to pool payments by their members and to purchase mutual fund shares at the lower sales loads applicable to large purchases.¹⁸⁷ In 1958, in response to "industry complaints" that the practice of group sales threatened the industry's "orderly distribution system,"¹⁸⁸ the SEC provided in rule 22d-1 that quantity discounts should not be available to "a group of individuals whose funds are combined, directly or indirectly, for the purchase [of fund shares or] a trustee, agent, custodian, or other representative of such a group."¹⁸⁹ The SEC justified its position on the ground that group sales are inconsistent with the policy against "discriminatory pricing policies" found in section 22(d), even though in rule 22d-1 it specifically sanctioned discounts for large purchases by single individuals for their own account and sales at a reduced load or no load to officers, directors, partners, and employees of the funds.¹⁹⁰

In October 1968 the SEC announced that it was considering amending rule 22d-1 to delete the clause prohibiting quantity discounts for group purchases. It stated that, as a result of its studies of the mutual fund industry, it "now believes that no disruption of the or-

¹⁸⁵ 15 U.S.C. § 13(a) (1964).

¹⁸⁶ *Baum v. Investors Diversified Services, Inc.*, 286 F. Supp. 914, 921 (N.D. Ill. 1968).

¹⁸⁷ SEC Investment Company Act Release No. 2798, at 46 (Dec. 2, 1958).

¹⁸⁸ *Id.* at 45.

¹⁸⁹ This was done by adopting a special definition of "person" for the purpose of rule 22d-1. "Person," as defined by §§ 2(a)(27) and 2(a)(8) of the Investment Company Act includes "any organized group of persons whether incorporated or not." In 1960 the SEC also ruled that groups which had been taking advantage of the quantity discount prior to the SEC's change of heart could not continue to do so on future purchases. SEC Investment Company Act Release No. 3015 (April 15, 1960).

¹⁹⁰ See *In re Travelers Equities Fund, Inc.*, BNA SEC. REG. & LAW REP. No. 19, at A-5 (Oct. 8, 1969) in which the NASD opposed a proposal by Travelers to offer shares without any sales load to employees of all Travelers companies as well as to contract sales representatives and their employees. Travelers subsequently limited its requested exemption and the NASD withdrew its opposition. See BNA SEC. REG. & LAW REP. No. 23, at A-15 (Nov. 5, 1969).

derly, effective distribution system of mutual funds shares would develop if mutual funds and their distributors were allowed, on a strictly voluntary basis, to afford quantity discounts to groups of individuals . . . on a uniform, nondiscriminatory basis."¹⁹¹ Industry spokesmen have opposed the amendment,¹⁹² and the SEC has as yet taken no further action.

D. *Periodic Payment Plans*

Special provisions are applicable to periodic payment plans (also known as "contractual plans" or "front-end load plans"). Under these plans, mutual fund shares are purchased by payment of monthly or other periodic fixed installments over a period of years. A distinctive feature of the plans is that, while the payments are generally spread over a period of ten years or more, a large part of the sales load on the total plan is deducted from the payments made during the first year.

Under section 27(a) of the Investment Company Act, the total sales load on the completed plan may not exceed nine percent of the total payments made by the purchaser, but up to one-half of each of the first twelve monthly payments may be deducted for sales load.¹⁹³ For example, a plan calling for payment of \$12,000 in 120 monthly installments of \$100 each can provide for a total sales load of \$1,080, obtained by deducting \$50 from each of the first twelve payments and \$4.44 from each of the remaining 108 payments.¹⁹⁴

In its 1966 *Mutual Fund Report*, the SEC recommended that front-end loads in the sale of mutual fund shares be prohibited and that the sales load be required to be uniform on all installments.¹⁹⁵ This recommendation was based on the finding that the substantial proportion of investors who signed up for these plans and who were unable or unwilling to continue making payments were penalized by sales charges that could run as high as fifty percent of the amount they had invested.¹⁹⁶

¹⁹¹ SEC Investment Company Act Release No. 5507, at 2 (Oct. 7, 1968).

¹⁹² See Simpson & Hodes, *The Continuing Controversy Surrounding the Uniform Price Maintenance Provisions of the Investment Company Act of 1940*, 44 NOTRE DAME LAW. 718, 724 (1969). While a majority of the comments opposed any discounts on group sales, a number of commentators indicated that they would approve the proposal if it could be limited to bona fide groups formed for unrelated purposes, and if other procedural problems could be resolved.

¹⁹³ MUTUAL FUND REPORT 230.

¹⁹⁴ The sale of periodic payment plans featuring a front-end load is prohibited or sharply limited in California, Illinois, and Wisconsin. CAL. ADMIN. CODE tit. 10, § 260.140.80; ILL. SEC. L. REGS., rule c-9; WISC. ADM. CODE, SEC 2.03.

¹⁹⁵ MUTUAL FUND REPORT 247.

¹⁹⁶ *Id.* at 22, 237.

The prohibition of front-end load plans was vigorously opposed by the Association of Mutual Fund Plan Sponsors, a trade association.¹⁹⁷ The mutual fund bill passed by the Senate in 1968 substituted a provision that preserved the nine percent sales load limit for the entire plan but provided that not more than twenty percent of any payment could be deducted for sales load. The bill also limited the average deduction for sales load on the first forty-eight monthly payments to sixteen percent.¹⁹⁸ The purpose of this provision was to permit the dealer to receive as much compensation on the first forty-eight monthly installments as he can receive under the present law, but to spread that compensation more evenly over the forty-eight-month period so that, no matter how early an investor dropped out of the plan, he could not be penalized by an effective sales load of greater than twenty percent.

The 1968 Senate bill also provided that when, in any month, an investor paid more than the minimum monthly payment called for by the plan, the sales load on the excess would be at the lower rate applicable to payments made after the first forty-eight monthly payments.¹⁹⁹ This provision was designed to deal with the situation in which, for example, a customer buying a fifty-dollar-a-month plan is induced to start with a lump-sum payment of \$600—equivalent to the entire first year's payments—on which the sales load would currently be \$300. The Senate committee felt that the practice of charging the higher load on lump-sum payments is "totally inconsistent with the industry's justification of the front-end load—that it is necessary to provide adequate compensation for the sale of mutual fund shares to people who are only able to invest small amounts of money at a given time."²⁰⁰

The bill passed by the Senate in 1969 retains the pattern of limitations found in the 1968 bill, but applies them only to plan sponsors who elect to be governed by them.²⁰¹ Non-electing plan sponsors would continue to be governed by the present limitations of section 27(a), subject to the proviso that if any investor redeemed his plan within three years from the time of his first payment, he would be entitled to receive (1) the value of his account under the plan, which would reflect any gain or loss in the net asset value of the underlying fund shares, plus (2) the amount by which the aggregate sales load he had paid

¹⁹⁷ *Hearings on S. 1659 Before the Senate Comm. on Banking & Currency*, 90th Cong., 1st Sess. 372 (1967).

¹⁹⁸ S. 3724, 90th Cong., 2d Sess. § 16 (1968). See also *1968 Senate Report* 16.

¹⁹⁹ S. 3724, 90th Cong., 2d Sess. § 16 (1968).

²⁰⁰ *1968 Senate Report* 17.

²⁰¹ S. 2224, 91st Cong., 1st Sess. § 17(f) (1969).

exceeded fifteen percent of his total payments made under the plan.²⁰² The plan sponsor would be required to notify any investor who had missed three payments or more during the first three years of the plan of his right to redeem and the amounts to which he would be entitled under this provision.²⁰³

The 1969 bill also provides that, within sixty days after any person invests in a plan, he must be sent a notice setting forth the charges to be deducted from his payments under the plan and notifying him that he has a right to withdraw from the plan within sixty days of the mailing of the notice and to receive (1) the value of his account, plus (2) the sales loads, custodian fees, and other expenses with which he has been charged.²⁰⁴ While the Senate Committee Report is unclear on the point,²⁰⁵ it appears that this right of withdrawal applies whether the plan sponsor elects to be governed by the limitation on sales loads or remains subject to present regulations with the new provision for a partial refund of sales load during the first three years of the plan.

E. *Additional Compensation for Sale of Mutual Fund Shares*

Although the portion of the sales load received by a broker-dealer is his basic compensation for the sale of mutual fund shares, there exist various means by which he can obtain additional compensation.

1. *Portfolio Brokerage—Reciprocity*

Trading by mutual funds in portfolio securities, mostly listed stocks, generates a great deal of commissions. The rapid growth of mutual funds in recent years, combined with an accelerated rate of portfolio turnover, has increased the importance of this source of compensation.

It has been the practice of mutual fund managers to direct the commissions from fund portfolio transactions to broker-dealers who sell shares of the fund or provide "research" or other services to the fund.²⁰⁶ Prior to December 5, 1968, this could be accomplished by directing the brokers to whom they gave the funds' orders for execution to "give up" portions of the fixed minimum commissions to the other broker-dealers whom the fund managers wished to reward. On that date the national securities exchanges prohibited these "customer-directed give-ups."²⁰⁷

²⁰² *Id.* § 16(c).

²⁰³ *Id.* § 16(d).

²⁰⁴ *Id.* § 16(e).

²⁰⁵ S. REP. NO. 91-184, 91st Cong., 1st Sess. 20 (1969).

²⁰⁶ MUTUAL FUND REPORT 169.

²⁰⁷ See text accompanying notes 45-54 *supra*.

This prohibition, of course, does not prevent fund managers from giving portfolio business directly to broker-dealers whom they wish to reward. This practice, however, is much more cumbersome than the "give-up." Furthermore, it may expose the fund manager to liability if he gives a portfolio order to a broker-dealer who, he has reason to believe, is not likely to be able to execute the transaction at the price most favorable to the fund.²⁰⁸ Aside from this fiduciary liability, a fund manager is potentially liable under the antitrust laws if he follows a regular practice of giving "reciprocal" portfolio commission business to particular broker-dealers for reasons unrelated to their ability to obtain the best execution for the fund.²⁰⁹ A broker-dealer may be similarly liable if he refuses to sell fund shares unless he gets reciprocal business. A number of consent judgments directed against reciprocal business practices of this nature have recently been obtained by the Justice Department under section 1 of the Sherman Act,²¹⁰ and the *Silver* and *Kaplan* cases²¹¹ give no reason to think that any implied exemption from the antitrust laws applicable to exchange fixing of minimum commission rates also insulates reciprocal arrangements from antitrust liability.²¹²

2. "Special Deals"

Outside the reciprocal brokerage area, the NASD considers it inconsistent with just and equitable principles of trade for a mutual fund underwriter, in connection with the sale of mutual fund shares, to give an NASD member "anything of material value in addition to the discounts or concessions set forth in the currently effective prospectus [of the mutual fund]."²¹³ This interpretation has been construed to apply to gifts of more than twenty-five dollars in value, loans and guarantees, sales of securities on a preferential basis, extra discounts, wholesale overrides, and travel expenses unrelated to attendance at bona fide business meetings related to the fund, but not to apply to oc-

²⁰⁸ See *Hubshman Management Corp.*, SEC Securities Exchange Act Release No. 8557 (March 20, 1969).

²⁰⁹ See *United States v. General Dynamics Corp.*, 258 F. Supp. 36 (S.D.N.Y. 1966). The court found that systematic reciprocal trading arrangements, whether coercive or based on mutual patronage, were anti-competitive practices and violated section 1 of the Sherman Act.

²¹⁰ Wall St. J., June 20, 1969, at 40, col. 1.

²¹¹ *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963); *Kaplan v. Lehman Bros.*, 250 F. Supp. 562 (N.D. Ill. 1966), *aff'd*, 371 F.2d 409 (7th Cir.), *cert. denied*, 389 U.S. 954 (1967).

²¹² See text accompanying notes 90-112 *supra*.

²¹³ NASD MANUAL, Interpretation of the Board of Governors ¶ 5262.

casional dinners or entertainment or to items of "reminder advertising" such as ballpoint pens and calendar pads.²¹⁴

The NASD also considers it improper for a member to compensate its salesmen for selling mutual fund shares in a manner that does not "bear a reasonable relationship to the dealer discount set forth in the prospectus."²¹⁵

3. *Sales Load on Reinvestment of Dividends*

In its *Mutual Fund Report*, the SEC found that more than half of the mutual fund shareholder accounts in existence in 1965 provided for automatic reinvestment of capital gains and dividend distributions. Although no fund charges a sales load on reinvestment of capital gains, almost half the funds at that time charged a full sales load on the reinvestment of income dividends.²¹⁶ A substantial part of this sales load is paid over by the underwriter to the dealer who originally sold the shares or, if he is no longer in business, to some other dealer. The SEC recommended that it be given authority to prohibit this "anomalous practice," on the ground that the reinvestment of dividends involves no sales effort justifying the imposition of a sales load.²¹⁷ Rather than giving the SEC the special authority it sought, the Senate committee left the matter to be dealt with under the general powers to regulate "excessive" sales loads granted to the NASD and the SEC by the Senate bill. The committee felt that the standards set forth in those provisions would "permit flexible treatment of the problem of sales loads on automatic investment of dividends, which involve little or no new selling effort."²¹⁸

V

UNDERWRITING

A. *Fixed Public Offering Price*

In the typical firm-commitment underwriting, the underwriters purchase stock from the issuer or selling stockholder and resell it either directly to the public or to "selected dealers" for resale to the public. The agreements among the underwriters and between the

²¹⁴ *Id.*

²¹⁵ *Id.* ¶ 5263.

²¹⁶ *MUTUAL FUND REPORT* 215.

²¹⁷ *Id.* at 223.

²¹⁸ *1968 Senate Report* 16.

underwriters and the "selected dealers" require that all sales to the public be made at the public offering price fixed by the underwriters, which provides for a profit, or "spread," above the price which the underwriters have agreed to pay the issuer or selling stockholder.²¹⁹

No express statutory provision exempts these resale price maintenance agreements from the antitrust laws. The SEC held in 1945, however, that "[t]he mere making of agreements containing provisions for a fixed offering price . . . is not *per se* unlawful" under the Sherman Act, although, "like many other contracts, these may be entered into and performed under circumstances that amount to an unlawful suppression of competition."²²⁰ But the SEC also held that the NASD has no authority to discipline a member who violates a price maintenance agreement.²²¹ The Commission felt that any rule or interpretation by the NASD requiring adherence to price maintenance agreements would be contrary to the provisions of section 15A(b)(8) of the Exchange Act, under which the rules of a national securities association may not be designed "to fix minimum profits . . . or . . . minimum rates of commissions, allowances, discounts or other charges."

Agreements among underwriters and with "selected dealers" also customarily provide that a discount from the public offering price may be allowed to any NASD member. Under the NASD's Rules of Fair Practice, a member is prohibited from dealing with non-member brokers or dealers except at the same prices as such member accords to the general public,²²² and this rule is interpreted to bar members from participating in any underwriting syndicate or selling group that includes non-members.²²³ This restriction against non-member participation in underwriting is a principal incentive for a broker-dealer to join the NASD.

B. *Level of Underwriting Compensation*

1. *Statutory Restrictions*

The federal securities laws impose no direct restrictions on the amount of compensation that may be paid to underwriters and dealers in connection with a public offering, but full disclosure of all under-

²¹⁹ *United States v. Morgan*, 118 F. Supp. 621, 693 (S.D.N.Y. 1953).

²²⁰ *National Association of Securities Dealers, Inc.*, 19 S.E.C. 424, 464 (1945). Judge Medina expressed his "complete agreement" with this position in *United States v. Morgan*, 118 F. Supp. 621, 699 (S.D.N.Y. 1953), an antitrust action against 16 leading underwriters.

²²¹ *National Association of Securities Dealers, Inc.*, 19 S.E.C. 424, 445 (1945).

²²² NASD Rules art. III, § 25.

²²³ NASD Rules, Interpretation of the Board of Governors following article III, § 24.

writing compensation is required in public offerings that are subject to the registration requirements of the Securities Act of 1933.²²⁴

By way of statute or regulation, a number of states impose detailed restrictions on the amount of underwriting compensation that may be paid on issues qualified for sale in those states,²²⁵ and other states give discretionary power to administrative officials to deny registration of an issue if "unreasonable" underwriting compensation will be paid.²²⁶

2. NASD Supervision

The NASD "five percent mark-up policy" is not applied to fixed-price underwritten offerings.²²⁷ Since 1961, however, the NASD has interpreted its Rules of Fair Practice as prohibiting members from participating in underwritings "in which the underwriting arrangements as a whole are unfair or unreasonable."²²⁸ In determining fairness or reasonableness, the NASD takes into account the size of the underwriting, whether it is being sold on a firm commitment or best efforts basis, the type of security, the nature and amount of compensation, and other relevant factors. In determining the amount of compensation, the NASD considers the gross amount of the underwriters' discount, any expenses borne by the issuer or selling stockholder that would normally be borne by the underwriters, and any stock or options acquired by the underwriters or related parties. The arrangements are normally considered unfair or unreasonable per se if the underwriters or related parties receive stock, options or warrants that are transferable within a period of one year from the date of the offering.²²⁹

To implement these restrictions, the NASD currently requires any member acting as managing underwriter of a registered or intrastate public offering to file with it, prior to the offering, copies of the

²²⁴ Securities Act of 1933, schedule A, item 17, 15 U.S.C. § 77aa (1964).

²²⁵ Selling commissions are limited to 15% of the offering price in a number of states. See, e.g., CALIF. ADMIN. CODE tit. 10, § 260.140.20; IND. SEC. COMM. REG., rule 19.02; MICH. DEP'T OF COMM., SEC. RULES, pt. 3, rule 706.5; MINN. REGS. S. DIV. 20; OHIO DIV. OF SEC. REG. CO-105(A).

²²⁶ The Uniform Securities Act contains a provision permitting the administrator to suspend or revoke a registration statement if the offering "has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation . . ." UNIFORM SEC. ACT § 306(F). This provision has been adopted in Alabama, Colorado, Hawaii, Indiana, Kentucky, Montana, Oklahoma, Oregon, Puerto Rico, Washington, and Wyoming.

²²⁷ NASD Rules, Interpretation of the Board of Governors following article III, § 4.

²²⁸ NASD Rules, Interpretation of the Board of Governors following article III, § 1.

²²⁹ *Id.* See also state restrictions discussed in *PLI's Conference on "Going Public,"* 2 REV. OF SEC. REGS. 846 (1969).

offering prospectus and other documents describing the underwriting arrangements. These are reviewed by the NASD's Committee on Underwriting Arrangements.²³⁰ A detailed set of guidelines for underwriters' compensation is reported to have been approved by the NASD Committee on Underwriting Arrangements and commented on by the SEC, and is expected to be issued early in 1970.²³¹ The number of issues reviewed by the committee increased from 428 in 1966 to 1,074 in 1967 to 2,108 in 1968. The underwriting arrangements in 328 issues were initially found "unfair or unreasonable" in 1968 as against seventeen in the previous year.²³² In almost all of these cases, the arrangements were modified to meet the committee's objections.²³³

VI

INTEREST INCOME

Interest charged on customers' margin accounts constitutes a substantial part of the income of broker-dealers, particularly that of the larger NYSE member firms. The income and expense reports filed by NYSE members doing public commission business in 1960 showed that thirteen percent of their gross income came from interest received from customers' balances.²³⁴

A. Disclosure of Interest Rate

The *Special Study* found that "normally money is lent to margin customers at the going call-money rate plus one or one-half point."²³⁵ Margin loans by registered broker-dealers were specifically exempted from the 1968 federal Consumer Credit Protection Act²³⁶ on the ground that the SEC already had authority under the Exchange Act to require appropriate disclosure.²³⁷

In December 1969 the SEC adopted a new rule 10b-16. It requires broker-dealers who extend credit to their customers to provide the customers with (1) an initial statement disclosing the basis on which interest will be charged, the initial interest rate, the conditions under which it may be changed, and any additional charges or liens; and

²³⁰ NASD Rules, Interpretation of the Board of Governors following article III, § I.

²³¹ 3 REV. OF SEC. REGS. 999 (1970).

²³² NASD, 1968 REPORT TO MEMBERS 6, 7.

²³³ *Id.*

²³⁴ SPECIAL STUDY, pt. 2, at 39.

²³⁵ SPECIAL STUDY, pt. 1, at 396.

²³⁶ 15 U.S.C. § 1603(2) (Supp. IV, 1969).

²³⁷ S. REP. NO. 392, 90th Cong., 1st Sess. 9 (1967).

(2) a quarterly statement disclosing the interest charged and the manner in which it was computed.²³⁸

B. *Use of Customers' Free Credit Balances*

The *Special Study* found that free credit balances in customers' accounts are an important source of financing for broker-dealers, particularly exchange members. Although a few states require segregation of customers' credit balances from firm assets, balances are generally available for firm operations, including the financing of loans to margin customers.²³⁹

Under SEC rule 15c3-2, adopted in 1964, a broker-dealer must, at least quarterly, send to each customer whose free credit balance may be used for the firm's business purposes a notice informing him of this fact and that the funds are payable to the customer on demand.²⁴⁰

The *Special Study* also found that most firms pay no interest to customers on these balances, and that those that do pay interest do so only on large balances that are reinvested within a short period of time. Frequently, interest is paid only when the customer requests it.²⁴¹ There is no rule requiring payment of interest on these balances; in fact, the NYSE prohibits its members from paying interest "on any credit balance created for the purpose of receiving interest thereon"²⁴² on the ground that to do so would violate section 21 of the Banking Act of 1933, which bars broker-dealers from engaging in the business of "receiving deposits."²⁴³ To implement this policy, the NYSE "has informally promulgated the view that interest can be paid on free credit balances only at a half point or more below the going call-money rate."²⁴⁴ The SEC's rule 15c3-2 does not adopt the recommendation of the *Special Study* that notice to customers disclose "that interest is not paid on such balances (or the circumstances in which interest is paid)."²⁴⁵

²³⁸ *Proposed*, SEC Securities Exchange Act Release No. 8594 (May 2, 1969); *adopted*, SEC Securities Exchange Act Release No. 8773 (Dec. 8, 1969).

²³⁹ *SPECIAL STUDY*, pt. 1, at 399.

²⁴⁰ *Proposed*, SEC Securities Exchange Act Release No. 7266 (March 12, 1964); *adopted*, SEC Securities Exchange Act Release No. 7325 (May 27, 1964).

²⁴¹ *SPECIAL STUDY*, pt. 1, at 395.

²⁴² NYSE rule 436.

²⁴³ 12 U.S.C. § 378 (Supp. IV, 1969).

²⁴⁴ *SPECIAL STUDY*, pt. 1, at 395.

²⁴⁵ *Id.* at 415. The SEC stated that "this information is not directly pertinent to the purpose of the rule; *i.e.*, to put customers on notice that free credit balances left with the broker-dealer may be used in the business and therefore may be at risk." SEC Securities Exchange Act Release No. 7325 (May 27, 1964).

CONCLUSION

There is no consistent or coherent pattern of regulation governing the charges which firms in the securities business levy on their customers. Price competition is drastically limited by a complex of restrictive rules and arrangements, but no comprehensive rational substitute for free competition has been developed. The pattern of regulation reflects historical developments and the interplay of political forces within and without the securities business. Recent changes in the nature of the market for equity securities, together with technological changes in the way the securities business is conducted, have emphasized the weaknesses of the current structure and will, hopefully, lead to the development of more satisfactory alternatives.