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STATEMENT TO THE SUBCOMMITTEE ON COMMERCE AND FINANCE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

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INTRODUCTORY STATEMENT

The Committee for the Martin Report presently comprises fifty-two registered broker-dealers, all of whom are members of the New York Stock Exchange and most of whom have memberships on other exchanges, including all of the regional exchanges. Shortly after the publication of Mr. William McChesney Martin's Report on the problems of the securities industry, some thirty-one of these firms determined that the course which Mr. Martin suggested for the securities industry was the one best calculated to maintain the best features of the country's securities distribution system, while at the same time providing the improvements and reforms which the experience of the past several years has indicated were necessary.

These hearings have been announced to "consider the questions of (i) commission rates, (ii) institutional membership on exchanges, and (iii) separation of brokerage and money management." Mr. Martin's Report and recommendations considered all three of these topics, but did so in the context of a much broader policy decision. That decision upon which all of the other recommendations in the

Report were based was that: "The public interest dictates that the primary purpose of a securities market is to raise capital to finance the economy," and that the mechanism to insure this must be a central auction market system nationwide in scope. We submit that no decisions may be reached on the questions presently before the hearings, unless this fundamental issue is first resolved.

The Committee for the Martin Report endorses the basic conclusion announced by Mr. Martin. We believe that the public interest in the United States demands a continuation of the broadly-based distribution system for securities which has been developed in this country, and that the system can only be preserved by the continuation of the present auction market system and its strengthening by additional centralization, uniformity of regulation and universality of disclosure.

We turn now to a consideration of the specific questions posed by the Subcommittee on Commerce and Finance in its invitation to us to appear at the hearings.

COMMISSION RATES

Our answers to the five questions propounded under the heading "Commission Rates" will be given with the assumption in mind that a central auction market, very similar to that which has been provided by the New York Stock Exchange over the years, is the keystone upon which the national securities market system will be based. Thus, whether or not there should or should not be fixed minimum commissions, and, if so, at what level they should stop, will be approached with this in mind. We believe that the consideration of this issue must be made independently of deliberation on the qualifications of

individuals or firms to be members of securities exchanges. We believe that the joining of these two issues and the treatment of them as being interdependent has caused nothing but confusion in the consideration of either of them. In short, whether or not financial institutions should be permitted to become members of national securities exchanges for the purpose of trading their own accounts has nothing to do with whether and to what extent the fixed minimum commission is abolished. As Mr. Martin has observed:

> "All of the arguments on both sides of the question of institutional membership have been weighed and considered. The public discussion of the subject has been confused by the concentration upon the question whether institutions should be entitled to access to exchange membership so that they may benefit by saving commissions. Appropriate commission charges for institutional orders are a separate question."

In addition, we believe that there is nothing inherently bad about fixed minimum commissions, and that the outcry against them as a system is unfounded and unnecessary. Far from being monopolistic, as some of its detractors have accused, it may very well be the most important single factor in encouraging the competitive system under which our securities markets have grown. We believe that a fair appraisal of the 150 year old minimum commission structure would lead to the following conclusions:

(a) The minimum commission system has served effectively to establish a maximum commission system, and has, accordingly, protected investors -- particularly small investors -- as a result.

(b) The minimum commission system has been the single most effective force in developing meaningful competition in the all-important area of service to the customer in the fiduciary atmosphere of principal and agent.

(c) The minimum commission system has been the keystone in the development of our present system of national securities distribution, having been the single indispensable element in the development of our regional New York Stock Exchange member firms.

(d) The minimum commission system has made it possible for the nation's broker-dealers to service the small investor -- not, it must be emphasized, at the expense of the large investor, but rather as an outgrowth of the securities market system as a whole.

(e) The evidence is overwhelming that the discontinuance of the minimum commission system would not only erode but, quite, probably, destroy the overall profitability of the securities industry.

(f) On the other hand, the discontinuance of the minimum commission system would result in a geometrically increased profitability for the very few giant securities firms which would survive. It would, accordingly, result in a geometric decrease in the number of broker-dealers who could compete for the public's business. The resultant decrease in competition is all too painfully obvious.

With this in mind, we answer the Subcommittee's questions as follows:

A. No one knows. Not only was there no factual basis for reducing the maximum limit from $500,000 to $300,000; there was never any basis in the first place for abolishing the fixed commission on even the largest trades. At any rate, before the commission rate system is drastically altered, far

more preliminary steps should be taken. Until a workable central auction market system has been formed and is in operation, it will continue to be impossible to determine whether fixed minimum commissions are necessary at any level. And the deleterious results to any auction market system which may come from any erosion of the profitability of the members which make it work, are so potentially destructive that guesswork should not be the basis for making any decisions.

B. We do not believe that there are any public policy reasons "which justify allowing competitively determined rates on institutional size orders, but fixed rates on smaller orders." The only public policy with which we would be concerned is that which we believe demands the central public auction market system as a prerequisite to a system of securities distribution which permits the raising of capital to finance the economy. Whether <u>this</u> demands competitively determined rates or fixed rates or unbundling of rates is the decision which should be made. We believe that the system demands a broad national distribution system, and that the smaller "regional" broker-dealer is an indispensable element in the system. Until it can be affirmatively determined that a fundamental change in the commission structure will not serve to weaken or destroy this public network of broker-dealers, then no steps should be taken further to reduce present limits.

C. If Congress determines that fixed prices are not in the public interest, it must, we believe, first have determined that abolishing them will not be irreparably damaging to the nation's securities distribution system. If it has made this determination, then, presumably, all fixed commissions should be abolished immediately, and Congress can do this much more expeditiously and quickly than the Securities and Exchange Commission. But we do not believe that either the Congress or the Securities and Exchange Commission at this date possesses anywhere near sufficient evidence to warrant the abrupt termination of the industry's traditional system of fixing commissions. It may very well be that such evidence will be gradually adduced. In the meantime, we would suggest, respectfully, that the Securities and Exchange Commission and the securities exchanges themselves are better able, with their existing experience and facilities for monitoring the health of the securities industry, to make at least preliminary determinations and, based thereon, to make their recommendations to Congress.

D. If Congress determines that legislation is required to provide for competitively determined rates on all transactions, it must first have made the preliminary determinations referred to in our answer to question "C". It should and could, presumably, act immediately. But, it is to us inconceivable that such an action could be taken prior to actions which would place regional securities firms (that is, those located outside of New York City) on an equal competitive basis with their New York-based competitors in such matters

as clearance, delivery of securities, central depositary services, etc. Our answer to this question, therefore, returns us to our original position that the establishment of the central market place with uniform regulation and paperwork reform should be considered by Congress to be a prerequisite to a restructuring of the commission system.

E. The suggestion that a system of "competitively determined commission rates" will require "institutions and others" to seek out the lowest execution price without consideration of other services which may be offered by competing brokers is one with which we have little sympathy. It is true that the investment company industry has been undergoing a round of litigation encompassing the fiduciary obligations of managers in the brokerage commission field. But so far there seems little basis for proposing as a rule of law that fiduciaries cannot consider all of the circumstances of a given securities transaction and choose an executing broker on the basis of the overall benefit to his beneficiaries to be derived from his choice. Obviously, the compensation of the fiduciary for the performance of his management function would be expected to show to some degree the amount to which the use of his managed fund's brokerage commissions have contributed to a saving of his expenses of management. We believe that this has always been the rule, and we observe that at least in the case of investment companies, it has been recently partially codified.

We believe further that a certain amount of investment advice is an integral part of the function of a broker-dealer, and that a certain amount of "research" is assumed before advice is given. We respectfully refer to

the statement and testimony of Mitchell, Hutchins & Co., Inc. provided to your Subcommittee at its hearings on April 14 and April 17. We believe this to be as comprehensive and erudite a description of the meaning and significance of research as we might possibly provide, and we concur in its conclusions.

INSTITUTIONAL MEMBERSHIP

We cannot state too emphatically our unanimous opinion that membership on a securities exchange which is acquired solely for the purpose of reducing or recapturing commissions otherwise payable to members of the exchange prostitutes the entire concept which was adopted by Congress in 1934 and has never been changed or abrogated. This is so regardless of the size of the individual or firm seeking membership. In fact, the size is really not the issue. Why should your Subcommittee be considering with such care the issue of whether large financial institutions should be permitted to save brokerage commissions by joining securities exchanges? If they are to be so permitted, should not all investors be entitled to join an exchange to save commissions? If the price of membership reached a low enough level or even a nominal level, would not all fiduciaries automatically be required to join exchanges? What would the results then be on the nation's securities distribution system? The issue before your Subcommittee is not that of the saving of brokerage commissions by the life insurance industry or the settlement of litigation by the investment company industry. The issue is what duties and obligations should be imposed upon members of national securities exchanges as a price for the enjoyment of the economic benefits which may be conferred upon members by virtue of their membership.

It is certainly appropriate to consider in some detail the legislative history of the Securities Exchange Act of 1934 as it applies to membership on national securities exchanges.

Discussion of Legislative History

> "Manipulators who have in the past had a comparatively free hand to befuddle and fool the public and to extract from the public millions of dollars through stock-exchange operations are to be curbed and deprived of the opportunity to grow fat on the savings of the average man and woman of America."

* * * *

> "The purpose of the Bill is to insure to the public that the securities exchanges will be fair and open markets. The Bill seeks to protect the American people by requiring membership of these exchanges to be wholly disinterested in performing their service for their clients and for the American people trading on the exchange."

The foregoing statements are those of Senator Duncan U. Fletcher made to the Senate of the United States on February 9, 1934, in introducing to the Senate a Bill then known as S.2693, which was to become later known as the Securities Exchange Act of 1934. S.2693 was followed on February 10, 1934, by a companion Bill introduced to the House of Representatives by Congressman Sam Rayburn as H.R.7852. These Bills were referred, respectively, to the Committee on Banking and Currency of the Senate and the Committee on Interstate and Foreign Commerce of the House of Representatives, and in the ensuing months public hearings were held on both Bills. Later, Senator Fletcher and Congressman Rayburn introduced identical Bills (S.3420 and H.R.8720), upon which further hearings were held.

Following these hearings Mr. Rayburn introduced H.R.9323, which was eventually enacted by both Houses as "The Fletcher-Rayburn Bill," and this Bill was signed by the President on June 6, 1934, as Public Law No. 291-73rd. Cong. 2d Session. We now know the Fletcher-Rayburn Bill as "The Securities Exchange Act of 1934" ("the 1934 Act").

At no time during future debate on the floor or in any of the Committees' Reports was there any indication of a departure by Congress from the concept enounced by Senator Fletcher of "performing their service for their clients and for the American people trading on the exchange." Quite to the contrary, the Report of the Committee on Interstate and Foreign Commerce of the House of Representatives, which reported out H.R.9323, stated clearly that:

> "The Bill proceeds on the theory that the Exchanges are public institutions which the public is invited to use for the purchase and sale of securities listed thereon, and not private clubs to be conducted only in accordance with the interests of their members." (H.R. 1384, p.15, emphasis added)

And as though to fortify this policy statement, Senator Fletcher stated on the floor of the Senate:

> "Under this Bill the securities exchanges will not only have the appearance of an open market place for investors but will be truly open to them, free from the hectic operations and dangerous practices which in the past have enabled a handful of men to operate with stacked cards against the general body of the outside investors." (78 Cong. Rec. 2271)

It is not surprising that so little debate was conducted on the floor of the Senate or that such little mention was made in the Senate and House Reports on this matter of membership on Exchanges. It is quite clear that the concern of the Congress was not whether membership should be restricted to those brokers or dealers doing business with the public, but rather, whether it should be restricted to brokers only, to the exclusion of dealers, whether or not

they were doing business with the public. In fact, the Bill as originally introduced included a provision prohibiting a member of an Exchange from acting in any way as a dealer in securities:

> "Sec. 10. It shall be unlawful for any member of a national securities exchange . . . to act as a dealer or underwriter of securities, whether or not registered on any national securities exchange . . . ."

But during the hearings in the Senate and House Committees, it was urged that segregation of the two functions -- that is, broker and dealer -- might seriously inhibit the conduct of the securities industry as it had developed in this country, and that such far-reaching legislation should not be passed without a full and complete study of the problem. Accordingly, the provision for complete segregation of broker and dealer functions was removed from the original Bill (it appeared as Section 10 of S.2693), and what became Section 11(e) of the 1934 Act was substituted for this harsh provision, and finally enacted into law:

> "Sec. 11(e). The Commission is directed to make a study of the feasibility and advisability of the complete segregation of the functions of dealer and broker, and to report the results of its study and its recommendations to the Congress on or before January 3, 1936."

The study thus ordered by Section 11(e) of the 1934 Act was subsequently undertaken by the Securities and Exchange Commission under the Chairmanship of James M. Landis, and the results were submitted to the President of the Senate and the Speaker of the House of Representatives (somewhat late) on June 20, 1936.

This study, entitled "Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker" ("the 1936 Report"), contained a classification of the then members of the New York Stock Exchange. (The "New York Curb Exchange" was included by the simple statement that the discussion of the New York Stock Exchange was "applicable" to the Curb Exchange, and then-existing regional exchanges were not discussed for the reason that "the functional classification of members is more sharply defined" on the New York Stock and Curb Exchanges.)

It would serve no immediate purpose to discuss this 1936 study of the Commission, other than to point out that it included a careful assessment of the problems and competing arguments in favor of and against the activities of eight classifications of members. These were (1) the commission broker, (2) the floor broker, (3) the floor trader, (4) the odd-lot dealer, (5) the odd-lot broker, (6) the bond broker and dealer, (7) the specialist, and (8) the inactive member. Significantly, the inactive member, whether trading on or off the floor, seemed to present the most serious problem to the operation of the market place, even in those days when this type of trading for the member's own account represented a relatively minor volume. In this regard, the following observations are significant insofar as they may relate to the legislative and regulatory history of the 1934 Act:

> "It is evident, therefore, that a member trading for his own account is in a position to trade with greater frequency to assure commitments at smaller costs, to profit from smaller price changes, and to incur less risk of loss, than a non member."

This comment was addressed to members who were trading their own accounts on the floor of the Exchange. Turning then to "the problem of trading by members off the floor," the Commission observed:

> "The apparent abuses in the handling of brokerage orders in conjunction with the various dealer activities which commission houses may carry on have already been described. At this point attention will be focused upon dealer transactions on the exchange, but not initiated on the floor, and the effect thereof."
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> "A member who trades from his office does not, of course, have the advantages which a member on the floor derives from his physical proximity to the center of trading. He does not enjoy the same instant access to information regarding the springing up of activity or the direction of prices. Nevertheless he usually maintains direct wires and other facilities by means of which he is kept currently posted with respect to developments on the floor. In this regard the member off the floor and all other professional traders, whether members or non-members, are in a position superior to that of the non-professional public." (1936 Report, p.48, emphasis added)

The 1936 Report of the Securities and Exchange Commission obviously was not concerned with the problem -- which was not to arise for two decades -- of membership on securities exchanges by large financial institutions whose sole motive was to "pay commissions for the execution of their transactions at rates substantially below those fixed for the public." (See 1936 Report, p.46) It is being cited rather to point up what is consistently obvious in the legislative history of the 1934 Act -- and that is, the concern of Congress

at that time was not whether it was desirable to throw open the doors of membership in the future to persons whose intent was only to trade for their own accounts, but rather, whether to exclude from membership in the future those not intending to conduct a brokerage function (as distinguished from a dealer function) with the public. Thus, the debate of 1934 in the halls of Congress was not that of whether a "primary purpose test" should be applied, but rather, whether the functions of a broker and dealer, both of which would satisfy the primary purpose test, should be segregated and the latter barred from membership. The very definition of "dealer" in the 1934 Act illustrates that the primary purpose test was simply assumed:

> "The term 'dealer' means any person engaged in the business of buying and selling securities for his own account . . . but does not include a bank, or any person insofar as he buys or sells securities for his own account, whether individually or in some fiduciary capacity, but not as a part of a regular business." (Sec. 3(a)(5), emphasis added)

We observe parenthetically that the definition of the term "member" appearing in Section 3(a)(3) of the 1934 Act does not qualify the terms "broker" and "dealer" insofar as discerning the intent of Congress is concerned. There were, of course, at the time of the passage of the Act "members" who were neither brokers nor dealers, and to the extent that the Act applied to those persons, the breadth of the definition of "member" was necessary.

We submit that the importance of this legislative history in the context in which we cite it is that nowhere was consideration given or concern expressed over the future admission to Exchange

membership of anyone not doing business with the public. And we submit that the action of Congress in not dealing specifically with the expulsion from the Exchanges of persons not so qualified was motivated purely by a reluctance to divest these individuals of valuable inchoate rights. Indeed, their number has been steadily dwindling, their function has been carefully proscribed and, in the case of floor traders, their responsibility to the public specifically increased and delineated. In short, the existence of the floor trader and other members trading for their own accounts prior to 1934 and the "grandfathering" of their existence can hardly be cited as precedent for the contention that the doors of the Exchanges should now be open to all comers.

Perhaps no single statement in the development of the 1934 Act so clearly describes the atmosphere in which it was drafted and from which it was born than the statement of one of its original draftsmen, Thomas G. Corcoran, Esquire, of the District of Columbia Bar. Testifying before the Senate Committee on Banking and Currency on the original version of the 1934 Act (S.2693), Mr. Corcoran stated:

> "As this section is drawn it says the exchange has no justification in the economic system except as a market place in which the orders of the investing public can be executed. Therefore, no one can be a member of the exchange except a broker." (Emphasis added)

As we have seen, it was decided at a later date provisionally to admit "dealers" as members -- but clearly those doing business with the public. At no time is there any indication that further compromise of the original provisions of the Bill were proposed by or would have been countenanced by Congress.

To summarize then, the purpose of a national securities exchange is to provide the public with a market place where investors, large and small, can purchase and sell securities in a regulated atmosphere. Membership on these exchanges carries certain economic benefits, among them the right to receive commissions for the execution of transactions for others, presumably at some profit. But the protection of investors and the public interest demands that membership carry concomitant obligations and duties. The most important of these is the duty to devote time, talent and capital to providing the public with its Congressionally-sanctioned market place. And that is what the primary purpose test is all about. With this in mind, we provide the following answers to the five questions under the heading "Institutional Membership."

A. Yes, institutions should be prohibited from joining national securities exchanges, directly or indirectly, to effect savings in commission costs. This is so whether or not fixed commission rates are required.

B. No, institutions should not be permitted a qualified form of access to national securities exchanges, nor should any other customers of member firms. (We assume that by the term "access" is meant some form of commission sharing or rebate or recapture.)

C. There are basic policy reasons for prohibiting institutional membership at any time. We refer to our discussion of the public nature of securities exchanges. "Institutional membership" means in the final analysis the abolition of the primary purpose test. This coupled with a major reduction in the cost of membership (an inevitable result, in our opinion, of the abolition of the primary purpose test) would totally destroy the public auction market.

D. Our logical answer to this question is that regardless of when exchange memberships have been acquired, the primary purpose test must be observed in all instances, irrespective of financial hardship. A "grandfather clause" is simply inconsistent with the provisions of the law and with the intent of Congress in enacting the provisions.

Congress does, on the other hand, have the latitude to consider the substantial inequities which might obtain in specific instances of acquisitions of membership, particularly during the 1960's when the staff of the Securities and Exchange Commission quite openly encouraged the acquisition of memberships on exchanges for the purpose of recapturing commissions. We believe this was a totally unjustified approach, that it was violative of both the letter and the intent of the Securities Exchange Act and the Investment Company Act, and that there resulted a temporary lapse in the enforcement of existing laws. But, we would agree that Congress should make every effort to temper the loss which might be incurred by unconditional enforcement of the primary purpose rule, whether by grandfather clause or income tax credit or outright subsidy of repurchase of memberships.

E. We believe that the Securities and Exchange Commission has authority under the Securities Exchange Act of 1934 to deal with the problem of enforcement of the Securities Exchange Act viewed in the context of the legislative history of the Act. That is, if Congress intended membership on securities exchanges

to be limited to those persons performing a public function, then the Securities and Exchange Commission must enforce the Act. But recent public statements and published correspondence from members of Congress and of the Senate have cast doubt upon the enforcement powers of the Commission, and it would appear that the existing confusion might best be removed by some overt act of Congress. We respectfully call attention to a Bill presently pending before the Senate, which was originally introduced by Senator Sparkman and Senator Bennett, the chairman and ranking minority member, respectively, of the Senate Committee on Banking, Housing and Urban Affairs. This Bill, now known as S.1164, would restrict membership on securities exchange to those doing business primarily with the public, and we would wholeheartedly support the passage of this Bill at any time.

SEPARATION OF BROKERAGE AND MONEY MANAGEMENT

Page after page of testimony was adduced at the hearings on the Structure, Operation and Regulation of the Securities Markets before the Securities and Exchange Commission. We have reviewed all of this testimony, and can only say that no generalization of any conclusion is possible on the issue of separation of brokers' functions.

One thing is certain, and that is that it is not possible to divorce the function of handling brokerage transactions for customers from the giving of advice to these customers on the wisdom of their investment decisions. The Securities and Exchange Commission

and the National Association of Securities Dealers have found good reason not to do so; we see this in its most rudimentary aspect in the so-called suitability rule of the Commission and the N.A.S.D.

Participating in the underwriting of a new issue of necessity involves the giving of investment advice by a broker to his customer. So does the receipt of a warrant by an existing customer of a broker -- that is, should he exercise the warrant or sell it? So does the year-end tax planning of a customer -- that is, should he sell to realize gains or losses, and if so what should he sell? If money management is to be divorced from brokerage, when does the function of the broker become money management?

There are many suggested solutions to the problem, and they would all seem to require the definition of money management to require the receipt of stated compensation for the advisory function separate and apart from any commissions which may be received for the transaction of securities orders. Mr. Martin found that to an extent this function should be permitted a broker-dealer, but he limited the extent to the point of excluding the management of a registered open or closed end investment company pursuant to a written contract. He did not defend this on the basis of anything but a "value judgment." On the other hand, it is not without a valid rationale. That is, that the relationship between a registered investment company and its investment adviser is unique in the law in that it is carefully delineated in the Investment Company Act of 1940, and now also in the Investment Advisers Act of 1940. There are prohibitions in the Act against certain joint dealings, and there are restrictions in the Act governing the composition of the board of directors of the investment company and the degree of affiliation between the investment

company and its adviser. There are specific requirements governing the duties of the directors of the investment company, vis-a-vis the advisory contract. There is a whole body of federal case law governing these relationships. In short, there is every reason to distinguish between a relationship so carefully singled out by Congress and the judiciary and the ordinary relationship between a broker-dealer and a managed account which is subject to no such statutory definition.

Based upon this introductory comment, we now provide you with our answers to the three questions under the heading "Separation of Brokerage and Money Management."

A. There is no necessity for Congressional action to require the separation of the functions of money management and brokerage. We reject the allegation that there is a conflict of interest in the exercise of both functions by the same entity. If anything, the performance of both functions by the same person for the same customer indicates a far higher degree of care than would even normally be the case. We also reject the argument that an unfair competitive advantage is presented to those entities performing both functions over those entities performing only one of the two functions. We observe briefly that the existence of this advantage would seem to be demonstrably refuted by the predominance in the money management field of banks and insurance companies having no broker-dealer affiliate.

We do concur in the recommendations of the Martin Report that there should be an elimination of any offset against advisory fees on account of brokerage commissions. This has traditionally caused more problems than it has solved, and the hearings before the Securities and Exchange Commission revealed a tendency on the part of money managers of all categories, including banks and brokerage firms, to purify their investment advisory and money management functions and the fees charged for these services.

B. As we have stated, we do not believe that any action is needed by Congress at this time.

C. The Martin Report determined that so long as the primary purpose test is complied with it should be permissible for broker-dealers who are members of exchanges to manage pooled investment accounts, but not registered investment companies. The members of the Committee for the Martin Report are not unanimous in the matter of the prohibition against the management of investment companies. With this exception, our answer is that it certainly would be equitable to permit broker-dealers who currently are members of exchanges to continue to manage mutual funds and other pooled investments, so long as this remains incidental to the performance of their public brokerage business. We observe that our rejection of the conflict of interest and unfair competition allegations requires this logical conclusion. And, finally, we again observe that the true test should be whether the membership on the exchange is being used to provide the public with its market place.

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