INSTITUTIONAL MEMBERSHIP AND THE EXPERIENCE OF THE PHILADELPHIA-BALTIMORE-WASHINGTON STOCK EXCHANGE

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On February 4, 1972, the Securities and Exchange Commission (SEC) issued a policy statement in the form of a special report entitled "Future Structure of the Securities Markets."[1] The policies announced in the report were designed to secure "three paramount objectives"[2] as a means of enabling the securities industry to "perform an even more vital function in the economy of our country."[3] The first objective was "to make the relationships in the securities market and their operation as simple, as direct, and as open"[4] as possible. To this end, the SEC has proposed a more competitive market structure which would compel brokers to discard reciprocal, rebative and recapturing practices and thereby to become more investor-oriented.[5]

The second objective was "to adapt the securities markets to growing institutionalization . . . while maintaining the confidence and the participation of the individual investor."[6] The SEC envisions a single "central market system" as the most efficient and effective means of achieving this objective.[7] Such a system is intended to centralize

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1 SEC Policy Statement, Future Structure of the Securities Markets, (Feb. 1972) [hereinafter cited as SEC Policy Statement].

2 Id. at 2.

3 Id. at 1.

4 Id. at 2.

5 Id. at 2-3. A "reciprocal" has been described as "an arrangement whereby, at the discretion of a customer or fund manager, the executing broker rewards a broker who has no role in connection with the execution of the transaction by furnishing him with unrelated business . . . designed to produce a specific level of commission. . . ." Miller & Carlson, Recapture of Brokerage Commissions by Mutual Funds, 46 N.Y.U. L. Rev. 35, 36 n.6 (1971) [hereinafter cited as Miller & Carlson].

A rebate occurs "[w]hen an executing broker at the direction [and for the benefit] of his customer [typically an investment adviser for a mutual fund or other type of financial institution] gives up part of the commission to another broker who has not participated in the transaction." Moses v. Burgin, 445 F.2d 369, 372 n.4 (1st Cir. 1971).

Recapture is the recovery of a portion of the executing broker's commissions for the direct benefit of the institutional investor. See Miller & Carlson, supra, at 55-71.

6 SEC Policy Statement, supra note 1, at 3.

7 Id. at 7-12. The SEC describes its proposed central market system as "a system of

the buying and selling of all listed securities and to facilitate the realization of the first objective—simple, direct and open relationships and operations. The SEC believes that a central market system would both strengthen the market, in order that it may better cope with the growing volume of institutional trading, and make the investing public aware of competition among the separate exchange markets, including listed stock prices and trade volumes.[8]

The final objective was to make "the professional service available to investors as efficient[ly] and economic[ally] as possible without diluting standards of service and responsibility."[9] To achieve this result, in light of the desired regulatory uniformity of a single central market system, the SEC has endorsed a limited form of membership on all stock exchanges for institutional members—broker-dealer affiliates of mutual funds and other institutional investors. More specifically, the brokerage subsidiaries of institutional investors would be required to conduct a "predominant portion" of their brokerage commission business for nonaffiliated sources.[10]

The SEC's opposition to unrestricted institutional membership is in large measure a response to the practice whereby institutional investors use their affiliated membership on an exchange "primarily as a vehicle for obtaining recapture of commissions."[11] William J. Casey, Chairman of the SEC, has stated that the Commission believes that it "is harmful to public confidence and to the kind of professional responsibility which should characterize our securities markets for brokerage firms to have the privilege of exchange membership without the obligation, the responsibility and primary purpose of serving a sector of the public other than their own affiliates."[12] However, this position ignores the fact that millions of individuals invest their savings in institutional pools of capital, and that these investors constitute a significant "sector of the public" which is served by affiliated brokers. In addition, the recent decision in *Moses v. Burgin*[13] indicates that money managers owe a fiduciary duty to institutional shareholders that requires managers to effect commission savings or to recapture commissions.

communications by which the various elements of the marketplace . . . are tied together. It also includes a set of rules governing the relationships which will prevail among market participants." Id. at 8.

8 Id. at 7-12.

9 Id. at 4.

10 Id. at 53-54. The SEC stated that "[p]redominant means . . . significantly more than half." Id. at 54. More recently, the Commission has indicated that "predominant" means "significantly more than two-thirds" and possibly as much as 90%. The New York Times, Feb. 6, 1972, § 3 (Business and Finance), at 9, col. 2.

11 SEC Policy Statement, supra note 1, at 48.

12 New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 2, cols. 2-3.

13 445 F.2d 369 (1st Cir. 1971).

If implemented, the SEC policy of restricted institutional membership will have a major impact on regional stock exchanges which presently allow affiliated brokerage membership.[14] The Philadelphia-Baltimore-Washington Stock Exchange (P-B-W) would be one of the most significantly affected regional exchanges since affiliated broker-members account for approximately fifty per cent of its business. In effect, the regional exchanges would have to adopt restrictive admissions requirements. On the other hand, the American and New York Stock Exchanges, which prohibit institutional membership, would have to broaden their admissions rules in order to comply with the SEC's policy.[15]

Since publication of the SEC's special report announcing the Commission's policy on institutional membership, a growing unrest, headed by the P-B-W, has developed among many regional exchanges.[16] Convinced that any benefits to be derived from restricting institutional membership would be speculative and remote, the P-B-W has reaffirmed its policy of unrestricted membership for broker-dealers affiliated with mutual funds and other institutional investors.[17] Some regional exchanges, notably the Midwest, Pacific Coast and Boston exchanges, have "expressed reservations about the Securities and Exchange Commission's institutional-membership plan [and] have been threatened with antitrust suits from concerns that would lose their membership if the eligibility rules were tightened."[18] Other exchanges which appear to have acquiesced to the SEC's plan have indicated that they will implement that policy only after being assured that all exchanges will cooperate simultaneously.[19]

This article will discuss the P-B-W's experience with institutional

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14 In addition to the Philadelphia-Baltimore-Washington Stock Exchange (P-B-W), other regional exchanges which presently have institutional members include: the Midwest Stock Exchange (MWSE), the Pacific Court Stock Exchange (PCSE), and the Boston Stock Exchange (BSE). The Cincinnati Stock Exchange does not have any institutional members, but its rules do not prohibit such membership. Wall Street Journal, March 2, 1972, at 2, cols. 3-4.

15 Id.

16 Id.

17 Id., Feb. 10, 1972, at 2, col. 2.

18 Id., March 2, 1972, at 2, col. 3. In response to a statement by SEC Chairman William J. Casey that institutional members should be required to conduct approximately 80% of their brokerage business with unaffiliated public investors, MWSE President Michael Tobin stated that this percentage was unnecessarily high for protecting public investors: "A figure as high as 80% would . . . not only be unduly restrictive in admitting new members but might cut out a considerable number of existing, traditional members that are basically brokerage houses but have created their own mutual funds or have emphasized advisory or management services." Id.

Thomas P. Phelan, President of the PCSE, stated that "the commission's proposals may have very serious anti-competitive effects, and we plan to examine this matter very closely and on a continuing basis." Id.

19 Id. at 2, col. 3.

membership. The advantages of broker-affiliated membership and an analysis of the arguments against institutional membership will then be examined in light of the recent SEC policy statement. Finally, it will be concluded that the continued growth of unrestricted institutional membership is in the public interest and that it will serve to strengthen the public securities market.

I. THE P-B-W'S EXPERIENCE WITH INSTITUTIONAL MEMBERSHIP

A. *Background*

The P-B-W is a national securities exchange which permits the membership of brokerage subsidiaries of institutional investors. Although the constitution of this Exchange states that member organizations must be principally engaged in the business of a broker or dealer in securities, this requirement refers only to the member and not to its parent affiliation.[20] In short, the P-B-W has no rules which prohibit institutional membership.

In December of 1967, the P-B-W claimed a total of 167 member organizations, of which four were affiliated with institutions. In 1968, the Exchange began admitting institutional affiliates in significant numbers; at present it has 317 member organizations, of which forty-five are broker subsidiaries of institutional investors. These affiliates were admitted because they satisfactorily met the P-B-W's eligibility standards, which require that the applicant (1) be financially responsible; (2) be run by professionally competent and experienced personnel; and (3) be associated only with persons of integrity who comply with the letter and spirit of the rules governing the Exchange.[21]

Unrestricted admissions requirements have been the primary factor in the increased number of institutional members in the P-B-W; in turn, this membership has substantially contributed to the growth of the Exchange and to its strength as an independent, competitive marketplace. In fact, from 1960-69, "[m]ost of the growth in the securities industry . . . was due to [an] increase in securities transactions by institutional investors. Moreover, since the average price of shares traded by institutions has always been higher than the average price of shares traded by individuals, the institutions accounted for an even higher proportion of the dollar volume on all exchanges."[22] Institutional members on the P-B-W presently execute approximately one-half of the orders transacted on the Exchange. As the institutional

[20] P-B-W Constitution, art. XIV, § 2.

[21] P-B-W Constitution, art. XI, § 6.

[22] SEC, Institutional Investor Study Report of the Securities and Exchange Commission, pt. IV, at 2311-12 (1971) [hereinafter cited as SEC Institutional Investor Study].

volume handled by these members has grown, there has been a corresponding enhancement in the ability of broker-affiliates to find purchasers or sellers for incoming orders on the floor of the Exchange. The result has been a substantial improvement in the ability of Exchange members to execute noninstitutional orders, which has led to the development of a willingness on the floor of the Exchange to position securities at risk. As a consequence of the P-B-W's growth and improved competitive position, the Exchange has been better able to serve directly the needs of sound but small broker-dealers unable to afford membership on the New York Stock Exchange (NYSE) and, indirectly, to serve the small individual customers of such firms.

B. *Capitalization*

Institutional membership on the P-B-W has also mitigated the effects of a problem currently plaguing the securities industry—undercapitalization. It has been observed that:

> "Capital" in the securities industry often takes the form of subordinated customers' accounts and volatile securities (used for speculative purposes) rather than liquid funds that would be fully available in a financial crisis.
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> Capital structures built on such an insubstantial base were strained by the firms' increasing need for funds. Members required capital not only to finance expansion of volume but also to obtain computers to service the increased volume and . . . to position blocks of securities.[23]

The capital committed by the institutional membership of the P-B-W, which exceeds fifty million dollars, is dedicated almost exclusively to broker-dealer activities, unlike that of many noninstitutional affiliates who, with increasing frequency, devote their capital to a multitude of nonsecurities activities. For example, many of the latter brokerage houses are "attempting to diversify into asset management. Like banks, some want to move into every aspect of investment and financial services."[24]

As a group, the institutional membership of the P-B-W operates under an aggregate indebtedness amounting to two to three times their net capital. Roughly translated, this fact means that these institutional members carry an aggregate indebtedness ranging between one hundred and one hundred fifty million dollars. This situation presents no real cause for concern since the institutional members of the P-B-W are in a better position to meet additional capital requirements than

[23] Carey & Werner, Outlook for Securities Markets, Harv. Bus. Rev. 17-18 (July-Aug. 1971) [hereinafter cited as Carey & Werner].

[24] Id. at 18.

most unaffiliated broker-dealers. The typical P-B-W institutional member has as part of its corporate complex a large parent corporation with ample funds to increase the capital of its affiliated member firm as the need occurs. By contrast, the typical nonaffiliated broker-dealer depends on much less accessible sources for capital—*i.e.*, the money of principals, subordinated private lenders and the public. The capital of nonaffiliated brokers would be strained to the breaking point if such members had to absorb an indebtedness proportionally comparable to that of institutional members, particularly since history has shown that private and public investors are reluctant to invest in a broker-dealer during adverse market conditions which may themselves give rise to further capital needs.

The securities industry is presently struggling for additional capital.[25] Expanded volume and probable limitations on the use of customers' funds by broker-dealer firms—a practice commonly referred to as *free credit balances*[26]—will increase the necessity for added capital. In response to this need, institutional membership has benefitted the securities industry, the P-B-W and other regional exchanges, and other member firms and their customers by adding capital to the industry and by keeping large orders within the exchange system. Under these circumstances, the regulatory authorities cannot ignore such a beneficial source of capital and the strength which institutional membership imparts to the public securities market.

II. Analysis of the Arguments Against Institutional Membership

A. *Unfair Cost-Savings Advantages*

1. *Fixed Minimum Commissions Rate Structure and Recapture—The SEC Policy Report*

Notwithstanding the favorable P-B-W experience, institutional membership has been unfavorably received in certain quarters, most notably the SEC. The Commission has cited the present structure of a fixed minimum commission rate within the securities industry as one reason for its opposition to institutional membership.[27] This rate structure imposes a fixed minimum brokerage commission on all orders

[25] Id. at 17-18.

[26] Free credit balances have been described as customer funds [which are] held by a broker and [which] are not . . . subject to any rules which restrict their use. Free customer credit balances form a substantial part of the working capital of many broker-dealers and are often used for the general operating needs of the broker-dealer's business, for financing its trading and investment accounts and for loans to other customers to finance margin [i.e., credit] transactions.

Miller & Carlson, supra note 5, at 75 n.187.

[27] SEC Policy Statement, supra note 1, at 28-34.

having a value of $500,000 or less.[28] Negotiated rates are permitted on that portion of each order which exceeds $500,000.[29] In fact, commissions charged on the latter portion are substantially lower than the fixed rate.[30]

To avoid or mitigate the cost of fixed brokerage commissions, many institutional investors affiliated themselves with brokers and effected substantial savings by means of recapture. However, the SEC stated that "[s]o long as such a [rate] structure exists, large investors should not, by virtue of their economic power and size, be entitled to obtain rebates of commissions not available to other investors."[31] In addition, the SEC decried recapture arrangements between institutional investors and their affiliated brokers as a "use of exchange membership for private purposes rather than for the purpose of serving the public in an agency capacity or otherwise performing a useful market function."[32]

The thrust of the SEC's fixed commission argument against institutional membership was that affiliated arrangements provide institutional investors with an unfair cost-saving advantage over smaller nonaffiliated investors. However, in its recent policy report the Commission removed some of the basis for this argument by announcing that no later than April, 1972, the negotiated rate level would be reduced to $300,000.[33] This reduction means that the fixed minimum commissions rate will apply only to orders having a value of $300,000 or less. SEC Chairman William J. Casey also has indicated that the Commission may eventually lower the negotiated rate level to $100,000.[34] In fact, Senator Harrison A. Williams, Chairman of the Senate Banking Subcommittee, has introduced a bill that would lower the negotiated rate level to $100,000 beginning after December 31, 1973.[35] Since negotiated commissions have proven to be substantially lower than the fixed minimum rates, nonaffiliated investors now will be able to effect significant savings. In addition, the reduced negotiated rate level will nearly eliminate any imbalance in cost savings which the SEC has alleged is unfair since "[t]here is general agreement that on transactions below $100,000 the potential savings available through exchange membership is much less significant."[36]

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28 Id. at 28.
29 Id.
30 Id. at 32. See also Wall Street Journal, March 9, 1972, at 3, col. 1.
31 SEC Policy Statement, supra note 1, at 46-47.
32 Id. at 47.
33 Id. at 33.
34 Wall Street Journal, March 9, 1972, at 3, col. 1.
35 S. 3347, 92d Cong., 2d Sess. (1972). See Wall Street Journal, March 13, 1972, at 8, col. 4.
36 Id.

Notwithstanding the impending action on the fixed minimum commission rate schedules, the Commission's opposition to institutional membership as a "use of exchange membership for private purposes"[37] is but a vague and groundless argument which is inconsistent with the institutional membership situation experienced by the P-B-W. Institutional membership on this exchange has permitted financial institutions to internalize brokerage functions within their corporate structure, thereby obviating the need to purchase brokerage services. As a result, millions of dollars in commissions have been saved by the institutions, savings which have been passed on to the millions of individual investors represented by those corporate investment pools. In addition, the SEC's public-private distinction is inconsistent in light of the fact that the Commission has not attempted to restrict certain "private" activities of noninstitutional members of the various stock exchanges. The SEC's proposal that exchange members should perform a "predominant portion" of their brokerage for unaffiliated customers does not seem to preclude private activity, currently allowed by the NYSE, whereby nonaffiliated brokers concentrate a substantial portion of their activities on principal trading for their own account.[38]

Further, pursuant to its position that "public" brokerage activity can occur only where "a predominant portion of [an exchange member's] brokerage commission business [is conducted] for non-affiliated persons,"[39] the SEC has stated that "[n]on-affiliated persons include individual discretionary and non-discretionary accounts and the accounts of non-affiliated institutions, but do not include institutional parents or investment companies or other institutional funds which are managed under contracts or arrangements which give the broker-

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[37] SEC Policy Statement, supra note 1, at 47.

[38] In a recent letter to the SEC, Elkins Wetherill, President of the P-B-W and co-author of this article, cited the following "private" activity which would not be prohibited by the Commission's proposal:

> [T]he Commission would permit Exchange membership to continue for firms: (a) which are substantially engaged in floor trading or other principal trading for their own accounts, or the accounts of their proprietors, in a non-market making capacity, and/or (b) which limit their customers services to a very narrow segment of the investing public, such as giant managed accounts, and/or (c) derive most of their profits, commit most of their capital and allocate most of their personnel to activities other than serving as a broker or dealer in publicly traded securities—for example, venture capital financing, mortgage banking, sale of commodities, real estate or insurance, etc. Viewed from this light, we think that our institutional members are much more appropriate for Exchange membership than are many of the existing "conventional" member firms.

Letter from Elkins Wetherill to William J. Casey, March 2, 1972, in 142 BNA Sec. L. Rep., at E-1 (March 3, 1972).

[39] SEC Policy Statement, supra note 1, at 47.

age firm investment discretion."[40] Implicit in this definition is that the sale of mutual fund shares or the shares of other institutional investors by a broker does not constitute public activity if, but only if, the issuer of the shares is managed by the broker—or an affiliate of the latter. This is an extremely arbitrary distinction for which the SEC has, as yet, offered no analytical justification, nor even an attempted explanation.

Significantly, neither the SEC nor anyone else has ever represented that institutional membership is not in the public interest. In fact, financial institutions represent a substantial portion of the investing public for whom affiliated exchange members faithfully perform brokerage services. Thus the recapture of commissions by institutional members is more aptly characterized as a benefit for a significant faction of the investing public, rather than the execution of a "private purpose." In addition, a recent decision by the United States Court of Appeals for the First Circuit has held that institutional money managers have a duty to effect brokerage commission savings whenever possible; the court further indicated that there may be a duty to recapture such commissions.

2. *Moses v. Burgin*

In *Moses v. Burgin*,[41] the investment adviser of a mutual fund had withheld information for an extended period of time from the unaffiliated, or "watch-dog,"[42] members of the Fund's board of directors. This information would have alerted the directors to the possibility, and in fact the practicability, of using recapture in order to reduce advisory fees.[43] Because of defendants' inaction, recapture was not

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40 Id. at 54.

41 445 F.2d 369 (1st Cir. 1971).

42 The court described the function and purpose of "watch-dog" directors of investment advisers as follows:

> Unlike an ordinary trust, or a business, management's normal activities are frequently touched with [a] self-interest [which benefits] management at least as much as . . . shareholders . . . . Congress . . . responded to this problem by enacting a mandatory provision for unaffiliated, that is, independent, watch-dog directors. 15 U.S.C. § 80a-10(a) [§ 10(a) of the Investment Company Act] . . . . Management [is] under a duty of full disclosure of information to these unaffiliated directors in every area where there [is] even a possible conflict of interest . . . .

445 F.2d at 376.

43 Information regarding the desirability of using recapture was presented to the Management defendants on two occasions. In June, 1965, in the course of SEC inquiries regarding the trading activities of the Fund on the Detroit Stock Exchange, an SEC representative suggested that the defendants could effect indirect recapture for the benefit of the Fund by obtaining "give-ups"—wherein at the direction and for the benefit of an investment adviser there is a relinquishment of some of the brokerage commissions on

effected by the Fund. As a result, a stockholder derivative action alleging a breach of fiduciary duty was instituted against the investment adviser and the Fund. More specifically, the plaintiff alleged that "Fund's give-up practices . . . resulted in the loss of the value of brokerage commissions which could have been recaptured . . . either by creation of a broker affiliate that could participate in Fund portfolio transactions, or by channeling present give-ups to an affiliate, with the result that in either case the sums involved would be credited to the fund."[44] The defendant argued that there was no duty to recapture, and that even if recapture could have been effected, as a practical matter, "the directors still had a right to choose between recapture of the give-ups for Fund's direct benefit, and awarding them to brokers for its indirect benefit."[45] In finding for the plaintiff, the court held that "if [recapture] was freely available to Fund, the directors had no such choice."[46] In making this determination, the court reasoned that although sound business reasons"[47] preclude the imposition upon a fund of a duty to acquire a broker affiliate, "[i]nsofar as a fund has a broker affiliate" there is a duty to recapture whenever practicable.[48]

The defendant also argued that recapture was illegal since it violated the "anti-rebate" rules of the various stock exchanges.[49] The lower court had agreed, adding that recapture has "the evil consequence of giving back to the customer a dollar credit traceable directly or indirectly to the commission he paid."[50] However, in response to this contention the Court of Appeals stated:

> The very fact that one type of rebate was uniformly tolerated by the exchanges despite their anti-rebate rules in itself shows that logic alone cannot supply the answer. The con-

a particular transaction by the executing broker to another broker not connected with the transaction—which could be offset against the advisory fee:

> The suggestion . . . should clearly have imparted to Management the idea that its benefit could now conflict with Funds' interest—and should, in turn, have made these defendants sensitive to the need for passing the suggestion along to the unaffiliated directors.

Id. at 377.

Again in 1966, SEC representatives conducting inquiries into commission rate structures suggested that recapture should be effected for the benefit of the Fund. Although the conflict was clearly presented to Management's attention, the watch-dog directors were still not informed. Id. at 378.

44 Id. at 372.

45 Id. at 374.

46 Id.

47 Id. at 375.

48 Id.

49 Id. at 381.

50 Moses v. Burgin, 316 F. Supp. 31, 57 (D. Mass. 1970). This statement by the district court has been criticized as overstating the limitation ascribed to the anti-rebate rules since dollar-for-dollar offsetting is allowed. 69 BNA Sec. L. Rep., at A-2 (Sept. 23, 1970).

trolling answer must be found in how the exchanges, who were the rule-makers, themselves translated their rules. We have seen that the Pacific and PBW exchanges, when confronted with proposals for recapture, chose to permit it.[51]

The First Circuit Court of Appeals was not alone in its recognition of a duty to recapture whenever practicable in broker-affiliate situations. Shortly after the *Moses v. Burgin* suit was instituted in December, 1971, the SEC issued a release proposing a new rule, 10b-10, which provided:

> (1) It shall be unlawful for any registered investment company or affiliated person of such registered investment company to directly or indirectly, to [*sic*] order or request any broker or dealer:
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> (a) to pay or arrange for the payment, directly or indirectly, of all or any portion of a commission on any securities transaction to any broker, dealer or any other person *unless* pursuant to a written contract the full amount of such remittance is required to be paid over to such registered investment company, or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to the remittance. . . .[52]

Although the acknowledged purpose of the proposed rule was to prohibit give-up practices, the release stated that "[t]he reasoning on which the proposed rule is based is that if . . . a mutual fund manager has various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, *he is under a fiduciary duty to do so*."[53] The Commission later withdrew the 10b-10 proposal, but only because the New York Stock Exchange and other exchanges initiated their own rules prohibiting give-ups.[54]

Both the *Moses* decision and the SEC release regarding rule 10b-10 confirmed the legality and desirability of recapture. The direct beneficiaries of recapture are the many individuals who have invested their savings in institutional investment programs. For example, in a mutual fund situation

> [i]f Fund receives the asset value of new shares, but at the same time rewards the selling broker with give-ups that it has a right to recapture for itself, then the net income Fund receives from the process of selling a share is less than the

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[51] 445 F.2d at 382.

[52] 33 Fed. Reg. 2393 (1968).

[53] Securities Exchange Act Release No. 8239 (Jan. 26, 1968) [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,523, at 83,085 (emphasis added).

[54] Miller & Carlson, supra note 5, at 35 n.1.

> asset value. The existing shareholders have contributed—by paying more than otherwise necessary on Fund's portfolio transactions—to the cost of the sale, which was supposed to have been borne by the new member alone.[55]

In addition, since institutional investors represent a significant portion of the investing public, and since the benefits of recapture accrue to these individuals, it must be concluded that recapture, made possible by institutional membership, is in the public interest.

3. *Other Motives for Affiliation and Congressional Criticism of the SEC Policy Report*

It should be noted that "reducing the cost of brokerage commissions to the accounts managed by the institutional investor"[56] has not been the only reason for affiliation between financial institutions and broker-dealers. Some affiliations "were motivated as investments for the parent rather than as a means of combining in one enterprise the brokerage and management of accounts";[57] other affiliations were the result of a desire by financial institutions "to be affiliated with an organized distribution system."[58] In its recent policy statement, the SEC found little objection with these motivations since the resulting membership usually included business dealings with those investors who have been vaguely characterized by the SEC as the "general public."[59] The Commission apparently condones such affiliations since they provide "a useful source of permanent capital for the securities industry."[60] Thus it would seem that the SEC's primary objection to institutional membership is really a result of the Commission's staunch opposition to recapture within a fixed minimum commissions rate structure. However, as has been discussed, the impending reduction in the negotiated rate level may obviate this objection.

In this respect the SEC's recent policy statement drew criticism from Senator Williams, for "moving so 'slowly and cautiously' to eliminate fixed rates and so 'promptly' to eliminate exchange memberships that some institutions have acquired for the purpose of reducing 'high' fixed-commission costs levied on their stock transactions."[61] Representative John E. Moss, Chairman of the House Banking Subcommittee, who also criticized the SEC for attempting to resolve the

[55] 445 F.2d at 374.

[56] SEC Institutional Investor Study, supra note 22, at 2296.

[57] Id. at 2299.

[58] Id. at 2300.

[59] SEC Policy Statement, Future Structure of the Securities Markets, at 49 (Feb., 1972) [hereinafter cited as SEC Policy Statement].

[60] Id.

[61] Wall Street Journal, Feb. 3, 1972, at 3, col. 2.

institutional membership issue "without waiting for congressional guidance,"[62] further stated that "the implementation of any far-reaching proposals, pending the final determination by Congress, [would not] be in the public interest."[63] To check the SEC's undue haste in this matter, Senator Williams has introduced a proposal which would remove the Commission's power to restrict institutional membership until one year after the $100,000 negotiated rate level is in force, at which time "we should be in a far better position to determine whether there is an 'institutional membership problem' or whether it is simply a symptom of the 'fixed commission rate problem.' "[64]

B. *Fragmentation of the Securities Market*

Another argument advanced against institutional membership is that the trend of institutional trading will "fragment" the securities market.[65] This trend has been characterized by an unprecedented growth in the volume of securities transactions[66] and by a corresponding pressure, generated by institutions, to lower commissions.[67] It has been suggested that this pressure plus "the inability of the specialist system to cope with the demands of an institutionalized marketplace"[68] will fragment the market by shifting trade away from the New York Stock Exchange to the regional stock markets, particularly the P-B-W.[69] In this way, the New York Stock Exchange has argued, "the realistic pricing of securities, reflecting the full forces of supply and demand, will be impaired."[70]

However, this argument is fallacious since it confuses the growing institutionalization of stock market trading with the growing institutional role in brokerage activity. The dramatic trend toward institutionalized markets which marked the decade of the 1960's[71] has not resulted from the relatively new, and as yet insignificant, phenomenon of institutional membership on exchanges. While it is true that the more trading an institutional investor funnels through its regional

62 Id.

63 Id.

64 S. 3169, 92d Cong., 2d Sess. (1972). See Wall Street Journal, March 13, 1972, at 8, col. 4.

65 See SEC Policy Statement, supra note 59, at 6; New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 2, col. 1; and Carey & Werner, supra note 23, at 17.

66 SEC Institutional Investor Study, supra note 22, at 2311. For example, on the NYSE securities transactions by institutional investors increased by 548% during the period 1960-69. Id.

67 Carey & Werner, supra note 23, at 17.

68 Id.

69 Id. See also New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 1, col. 8, and at 2, col. 1.

70 New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 2 col. 1.

71 See note 66 supra.

exchange broker-affiliate the less commission income NYSE members receive, this factor is a result of the NYSE's outmoded prohibition against broker-affiliates,[72] and not a fault of institutional membership. In addition, the lowering of the negotiated rate level to $300,000 will result in reduced commission income for brokers on all exchanges, and the proposed $100,000 level, if enacted, will remove any remaining illusory vestiges which might have been used as a basis for the "fragmentation" argument.

The SEC's recent endorsement of a single, totally-integrated market also strikes at the heart of this argument. Because of technological developments in computerized communication, the central market system will provide all marketplaces with readily available information on completed trades, as well as quotations in all marketplaces. In this way, "the realistic pricing of securities, reflecting the full forces of supply and demand,"[73] will be assured, notwithstanding any shifts in trade volume from one marketplace to another. In addition, since the central market system will require the "[e]stablishment of terms and conditions upon which any qualified broker-dealer [including institutional affiliates] can obtain access to all exchanges,"[74] there will be little likelihood that trading will be diverted to "inappropriate" marketplaces so as to distort "the realistic pricing of securities."

C. *The Dealer-Oriented Market*

It has also been argued that institutional membership ultimately may cause the brokerage business to become dominated by financial institutions intent on building captive sales forces.[75] It is contended that this build-up could lead to a dealer-oriented market. It is further argued that such a market would eliminate the broker-customer agency relationship by driving small, nonaffiliated brokerage firms out of business, and by eliminating the individual investor's ability to trade against institutions.[76] However, if the increasingly institutionalized markets are leaning more toward the dealer function of selling shares, it is because this orientation is better suited to satisfy the legitimate needs of institutional investors, through whom millions of Americans invest. For example, the continual selling of shares is of

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[72] This prohibtion is embodied in NYSE Rule 318, CCH NYSE Guide ¶ 2318 (1970).

[73] New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 2, col. 1.

[74] SEC Policy Statement, supra note 59, at 10.

[75] See New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 2, col. 1; and, Miller & Carlson, Recapture of Brokerage Commissions by Mutual Funds, 46 N.Y.U. L. Rev. 35, 75 (1971).

[76] New York Times, Feb. 20, 1972 § 3 (Business and Finance), at 2, col. 1-2.

particular importance to a mutual fund, which must always be prepared to redeem its shares:

> A continual flow of new money may be beneficial in giving the adviser more flexibility in managing the portfolio, in achieving long-term investment goals and in avoiding sales of portfolio securities at inopportune times to meet redemptions. . . . Additionally, continual sales might reduce the per share portion of the management fee funds which scale down fees as assets under management increase.[77]

Thus it would seem that the extent to which the securities market has been, and will become, dealer-oriented will be determined by the level of institutionalization of the market, not institutional membership. In fact, contrary to the dangers attributed to institutional membership, the P-B-W has been inundated by no adverse impact on nonblock trade volume (orders of less than 2,000 shares)[78] as a result of its unrestricted membership policy.

It is interesting to note that many firms own seats on the NYSE in order to trade for their own account,[79] and some deal more for such accounts rather than acting as broker-agents for customers. Yet, no one has suggested that these firms should lose their NYSE membership because of their dealer orientation. Nor has it been expressed that these firms should be required to devote more of their resources to servicing the individual investor.

D. *The Subsidization of Nonaffiliated Members*

Implicit in the preceding argument by the NYSE that institutional membership will result in a substantial decline in the number of broker-dealers available to serve individual investors is the suggestion that broker affiliations should be prohibited in order that the profits derived from institutional brokerage commissions might accrue to nonaffiliated brokers, to subsidize the brokerage services available to such investors.

[77] Miller & Carlson, supra note 75, at 65. In fact, in February, 1972, mutual fund redemptions exceeded sales by $88,000,000, and the industry experienced net redemptions during 5 of the 12 months preceding this date. The New York Times, March 21, 1972, at 57, col. 7.

[78] The SEC has suggested that block trade could be defined as "a securities transaction that, because of its size or other characteristics, requires special handling." SEC, Institutional Investor Study Report of the Securities and Exchange Commission, pt. IV, at 1537 (1971) [hereinafter cited as SEC Institutional Investor Study]. However, the Commission recognized that this definition is inadequate, and possibly for this reason the various exchanges have defined block trades in terms of order sizes. For example, the NYSE generally defines block trade as orders of 10,000 or more shares. Id. at 1537. Most regional exchanges, including the P-B-W, define block trades as orders of 2,000 or more. Id. at 1819.

[79] Carey & Werner, Outlook for Securities Markets, Harv. Bus. Rev. at 23 (July-Aug. 1971).

In effect, this suggestion of a subsidy would necessitate subjecting brokers handling institutional accounts to public-utilities type regulations, which would insure that the brokers did in fact subsidize and service the small investors as well as the financial institutions.

However, available statistics support neither the subsidy approach nor the argument upon which the suggestion is based. The NYSE presently prohibits institutional membership[80] and, therefore, approaches the operating conditions favored by that exchange. Of the more than 250 member firms on the NYSE, only approximately one and one-half per cent of these members derive twenty-five per cent or more of their gross income from institutional commissions.[81] Approximately thirty-six per cent of the NYSE members derive less than five per cent of their gross income from institutional commissions,[82] and over eighty per cent of the member firms derive no more than fifteen per cent of their commission income from institutions.[83] Simply translated, these statistics indicate that exchange membership for institutional dealer affiliates on the NYSE would affect, at most, only a small percentage of nonaffiliated members.

In addition, even though affiliated firms would be primarily engaged in institutional brokerage business, not retail activities for individual public investors, such a situation would be substantially identical to the existing NYSE business pattern. This result would occur notwithstanding the imposition of a subsidy situation. As discussed above, subsidization would require the promulgation of public-utility type regulations. However, not even the NYSE has suggested imposing such rules on brokerage firms. Thus the subsidy approach would fail in its objective since the recipients of the subsidy—nonaffiliated brokers for institutional investors—need not, and by and large presently do not, render the services to individual investors which are intended to be subsidized.

E. *Conflicts of Interest*

Finally, the NYSE has argued that institutional membership poses unique conflict of interest problems.[84] It is alleged that affiliated members may effect unnecessary brokerage activity through unwarranted portfolio turnover—churning[85]—in order to generate commissions, and that broker affiliates may avoid marketplaces from which the best execution is available. However, since many institutional

80 See note 72 supra.

81 SEC Institutional Investor Study, supra note 78, at 2236.

82 Id.

83 Id.

84 Carey & Werner, supra note 79, at 23.

85 Id.

members are wholly-owned subsidiaries of their parent institutions whose profits accrue directly to the parent, no unique conflict of interest is presented. In fact, the relationship between an affiliated member firm and its parent is more free from potential conflict of interest problems than that of the conventional nonaffiliated broker and its customer.

It should be noted that potential conflicts of interest do arise in "fund complex" arrangements.[86] In this situation, a group of financial institutions are externally managed "by separately owned and operated organizations known as investment advisers or managers."[87] Here, the broker-dealer is a subsidiary of the external money manager and performs brokerage services for an investment pool not beneficially owned by the parent-manager. Thus the external management structure is conducive to conflicts of interest, since "the manager does benefit from reciprocity in increased fund share sales commissions and management fees and does benefit where its affiliate retains commissions on fund portfolio brokerage."[88]

However, since broker-dealers affiliated with institutions do perform brokerage services for investments beneficially owned by the institutional parent, this conflicts situation is not present in the institutional membership situation. In fact, with the exception of institutional membership arrangements, this particular conflict is common to the securities industry whenever the functions of a money manager and broker are combined. Many NYSE members are permitted to combine these functions, while institutional applicants performing identical duties are denied NYSE membership.[89] Gustave Levy, former Chairman of the NYSE, has conceded that "[o]ur Achilles heel has always been that we have been in the money-managing business, but the managers could not get into ours."[90] In fact, the SEC has indicated that:

> [I]n enacting the Investment Company Act Congress apparently did not find it necessary that the brokerage and investment company functions be completely separated. There are potential conflicts of interest in these relationships, as well as in the broker-underwriter relationship, the money manager-underwriter relationship and the dealer-money manager relationship. If all of these functions were to be separated, the capital-raising capability of the industry and its ability to serve the public could be significantly weakened. We there-

[86] Miller & Carlson, supra note 75, at 42.
[87] Id.
[88] Id. at 49-50.
[89] Carey & Werner, supra note 79, at 23.
[90] Id.

fore believe that the conflict of interest problem which is inherent in the combination of money management and brokerage is a matter to be resolved by Congress.[91]

Conclusion

The P-B-W's experience with institutional membership indicates that affiliated membership is beneficial to the exchange, to its non-affiliated members and their customers, and to the investing public. The volume of trade generated and the capital committed by the institutional members have contributed substantially to the growth of the P-B-W, strengthening the position of the exchange as an independent competing marketplace. As a result, the P-B-W has been able to serve directly the needs of sound, but small, nonaffiliated firms that are unable to afford NYSE membership. In this way, the exchange has been able to serve, indirectly, the small individual customers of those firms.

Institutional membership has been attacked, primarily by the SEC, as being contrary to the best interests of the securities industry. The underlying reason for this opposition is the cost-savings advantage which accrues to institutional investors. However, the impending reduction of the negotiated rate level and the recent decision in *Moses v. Burgin* have substantially vitiated the recapture argument. Other arguments—concerning fragmentation of the industry, the evolution of a dealer-oriented market and the subsidization of non-affiliated members—must also be discounted, since they represent problems inherent in the institutionalization of the securities market, which is not to be confused with institutional membership.

Further, it is recognized that institutional membership does not present a potential conflict of interest problem in the external management situation. This potential conflict is a product of the investment manager-broker relationship. However, with the exception of institutional membership, this relationship and the attendant conflicts problem are familiar to the securities industry. Institutional membership has significantly benefitted the securities industry by providing capital commitments and by keeping large orders within the exchange system. The continued growth of such membership, untramelled by restrictions based on artificial justifications, will undoubtedly strengthen the public securities market.

[91] SEC Policy Statement, supra note 59, at 52-53.