CHAPTER XIII

IMPACT OF INSTITUTIONAL TRADING ON BROKERAGE SERVICES AND THE SECURITIES INDUSTRY

DETAILED TABLE OF CONTENTS

Page

A. INTRODUCTION 2157
1. Scope of Chapter 2157
2. Sources of Data 2157

B. LONG TERM IMPACT OF INSTITUTIONAL INVESTORS ON THE SECURITIES INDUSTRY 2160
1. Overall Trends in the Securities Industry 2160
2. Growth in Institutional Investor Payments to the Securities Industry 2167
3. Impact of increased institutional investor business on securities industry profitability 2170
   a. Total business 2170
   b. Security commission business 2170
   c. Other business 2172
4. Distribution of Increased Institutional Investor Business 2182
5. 1968 Commission Rate Changes 2199
6. Impact of 1968 Commission Rate Changes 2205
7. Overall and Institutional Investor Trends 1969–70 2099
8. Profitability of Institutional Investor Business in 1969–70 2213
   a. Total business 2213
   b. Security commission business 2214
   c. Other business 2215

C. ALLOCATION OF COMMISSION AND OVER-THE-COUNTER BUSINESS BY INSTITUTIONAL INVESTORS 2226
1. Commissions Paid by Institutional Investors 2226
   a. Magnitude of commissions paid by institutional investors 2226
   b. Concentration of commissions paid by institutional investors 2226
   c. Characteristics of broker-dealers receiving commissions from institutional investors 2227
   d. Institutional investor commissions as a percent of broker-dealer gross income 2228
2. OTC Net Trades in Stocks by Institutions 2239
   a. Magnitude of institutional investor OTC net trades 2239
   b. Concentration of broker-dealers OTC net trades with institutions 2239
   c. Characteristics of broker-dealers with OTC net trades with institutions 2240
3. Customer Designation of Broker-Dealers 2249
   a. Reasons for customer designation of broker-dealers 2249
   b. Magnitude of customer designation of broker-dealers 2249
   c. Importance to the broker-dealer of customer designation 2250
4. Execution and Clearance 2255
   a. Agency executions 2255
   b. Principal executions 2255
   c. Trading discretion given to broker-dealers 2258
   d. Clearance and settlement 2258

	Page
5. Institutional Investor Payments for Research	2263
a. Magnitude of institutional investor payments for research	2263
b. Concentration of research commissions	2264
c. Importance of research commissions to broker-dealers	2264
d. Research expenses of broker-dealers	2265
6. Other Services Offered to Institutional Investors	2273
a. Portfolio valuation	2273
b. Custody of securities	2273
c. Margin accounts	2274
d. Communications	2274
7. Reciprocity	2277
a. Introduction	2277
b. Bank commission payments to broker-dealers with commercial relationship	2278
c. Commission payments to broker-dealers selling mutual fund shares	2283
d. Insurance companies and broker-dealer reciprocity	2285
D. Affiliatons Between Institutional Investors and Broker-Dealers	2296
1. Types of Affilations Between Institutional Investors and Broker-Dealers Dealers	2296
a. Reducing the cost of brokerage commissions to the accounts managed by the institutional investor, often while increasing the income of the institutional investor, itself	2296
(1) Investment adviser affiliates established by broker-dealers	2296
(2) Broker-dealer affiliates established by investment advisers and other institutional investors	2298
b. Diversifying the business of the institutional investor in the financial area while supplying additional sources of capital to the broker-dealer	2299
c. Using the distribution facilities of an affiliated broker-dealer to sell the services provided by the institutional investor	2300
2. The Legal Environment	2304
3. Stock Exchange Requirements	2305
a. The New York Stock Exchange	2305
b. Philadelphia-Baltimore-Washington Stock Exchange	2308
c. The Pacific Coast Stock Exchange	2308
d. Midwest Stock Exchange	2310
E. Summary and Conclusions	2311
1. Long-Term Impact of Institutional Investors on the Securities Industry	2311
a. Overall trends in the securities industry	2311
b. Growth in institutional investors' payment to the securities industry	2311
c. Impact of increased institutional investor business on securities industry profitability	2312
d. Distribution of increased institutional investor business	2313
e. 1968 Commission rate changes	2313
f. Impact of 1968 Commission rate changes	2314
g. Profitability of institutional investor business in 1960–70	2314
2. Allocation of Commissions and Over-the-Counter Business by Institutional Investors	2314
a. Commissions paid by institutional investors	2314
b. OTC net trades in stocks by institutional investors	2315
c. Customer designation of broker-dealer	2316
d. Execution and clearance	2316
e. Institutional investor payments for research	2318
f. Other services offered to institutional investors	2318
g. Reciprocity	2319
3. Affiliations Between Institutional Investors and Broker-Dealers	2320
a. Types of affiliations between institutional investors and broker-dealers	2320
b. The legal environment	2321
c. Stock exchange requirements	2321

LIST OF TABLES

Table Number		Page
XIII-1	Gross Income, New York Stock Exchange Member Firms, 1962-1968	2162
XIII-2	Sources of Income, New York Stock Exchange Members, 1962-1968	2163
XIII-3	Gross Commission Income, New York Stock Exchange Member Firms 1962-1968	2164
XIII-4	Pre-Tax Profit, Total Business, New York Stock Exchange Member Firms, 1962-1968	2165
XIII-5	Pre-Tax Profit, Commission Business, New York Stock Exchange Member Firms, 1962-1968	2166
XIII-6	Estimated Share Volume on the NYSE, Institutional and Individual Investors, 1960-1969	2168
XIII-7	Average Share Size of Order Executed on NYSE By Selected Institutions	2169
XIII-8	Pre-Tax Profit, Total Business, By Commission Income Per Transaction, NYSE Member Firms, 1968	2173
XIII-9	Median Pre-Tax Profits By Commission Income Per Transaction, New York Stock Exchange Member Firms, 1968	2174
XIII-10	Pre-Tax Return on Capital, Total Business By Commission Income Per Transaction, NYSE Member Firms, 1968	2175
XIII-11	Pre-Tax Profit, Commission Business By Commission Income Per Transaction, NYSE Member Firms, 1968	2176
XIII-12	Pre-Tax Profit Margin on Commission Business By Commission Income Per Transaction, NYSE Member Firms, 1968	2177
XIII-13	Median Profit Margin on Commission Business By Commission Income Per Transaction and Security Commission Gross Income, NYSE Member Firms, 1968	2178
XIII-14	Index of Income, Costs and Profit Margin For Various Size Orders, NYSE Member Firms, Pre-December 5, 1968	2179
XIII-15	Sources of Income Other Than Security Commissions, New York Stock Exchange Members, 1968	2180
XIII-16	Pre Tax Profit On Other Business By Commission Income Per Transaction, NYSE Member Firms, 1968	2181
XIII-17	Average Commission Income Per Transaction, 1962 and 1968, New York Stock Exchange Member Firms	2190
XIII-18	Percent of Total Commission By Income Per Commission Transaction, NYSE Members, 1962-1968	2191
XIII-19	Give-Ups Paid At the Direction of Advisors to Investment Companies, New York Stock Exchange Member Firms, 1964-1968	2192
XIII-20	Investment Company Commission Received and Given-Up, New York Stock Exchange Member Firms, 1968	2193
XIII-21	Institutional Investors Other Than Investment Company Advisers Directing Commissions, 1968	2194
XIII-22	Give-Ups Paid at the Direction of Investment Companies, New York Stock Exchange Member Firms, 1964-1968	2195
XIII-23	Percentage Distribution of NYSE Member Firms By the Amount Given-Up or Received at the Direction of Institutional Investors, 1968	2196
XIII-24	Percent of Investment Company Commissions Received as Give-Ups, New York Stock Exchange Members, 1968	2197
XIII-25	Percent of Investment Company Commissions Received Which Was Given-Up, New York Stock Exchange Member Firms, 1968	2198
XIII-26	NYSE Commission Rate Schedule, Effective December 5, 1968	2202
XIII-27	NYSE Commission Rates Before and After December 5, 1968	2203
XIII-28	NYSE Commission Rates Before and After December 5, 1968	2204
XIII-29	Actual Commissions Received From Investment Companies 1968-1969 By 1968 Give-Up Balance, New York Stock Exchange Member Firms	2207
XIII-30	Impact of the Volume Discount and the Abolition of Investment Company Directed Give-Ups, New York Stock Exchange Member Firms, 1969	2208

53-940—71—pt. 4——49

Table No.		Page
XIII-31	Dollar Volume on Exchange and NYSE Member Firms' Commission, 1968-1969	2210
XIII-32	Income From Sources Other Than Commissions, NYSE Member Firms, 1968-1969	2211
XIII-33	Selected Institutions Total Purchases and Sales of Common Stock	2212
XIII-34	Pre-Tax Profit, Total Business, By Commission Income Per Transaction, NYSE Member Firms, 1969	2216
XIII-35	Median Pre-Tax Profit, By Commission Income Per Transaction, New York Stock Exchange Member Firms, 1969	2217
XIII-36	Difference in Median Pre-Tax Profits, By Commission Income Per Transaction, New York Stock Exchange Member Firms, 1968-1969	2218
XIII-37	Pre-Tax Return on Capital, Total Business By Commission Income Per Transaction, NYSE Member Firm, 1969	2219
XIII-38	Expenses of NYSE Member Firms, 1968-1969	2220
XIII-39	Pre-Tax Profit, Commission Business By Commission Income Per Transaction, NYSE Member Firms, 1969	2221
XIII-40	Pre-Tax Profit Margin, Commission Business By Commission Income Per Transaction, NYSE Member Firms, 1969	2222
XIII-41	Percent Difference Between 1969 Cost Per Order and Minimum Commission Rate Effective December 5, 1968	2223
XIII-42	Pre-Tax Return on Capital, Commission and Margin Interest Business, By Commission Income Per Transaction, NYSE Member Firms, 1969	2224
XIII-43	Pre-Tax Profit Other Business by Commission Income Per Transaction, NYSE Member Firms, 1969	2225
XIII-44	Institutional Investors, Commissions Paid to Broker-Dealers, 1968	2229
XIII-45	Institutional Investors, Number of Broker-Dealers Receiving Commissions, 1968	2230
XIII-46	Concentration of Commissions Paid by Institutional Investors, Calendar Year 1968	2231
XIII-47	Commissions Received by Broker-Dealers from Institutional Investors, Calendar Year 1968	2232
XIII-48	Distribution of Broker-Dealers by Commissions Received from Institutional Investors and Exchange Membership, Calendar Year 1968	2233
XIII-49	Distribution of Broker-Dealers by Commissions Received from Institutional Investors and Total Capital, Calendar Year 1968	2234
XIII-50	Distribution of Broker-Dealers by Commissions Received from Institutional Investors and Total Gross Income, Calendar Year 1968	2235
XIII-51	Distribution of Broker-Dealers by Percent of Gross Income Derived from Institutional Commissions and Exchange Membership, Calendar Year 1968	2236
XIII-52	Distribution of Broker-Dealers by Percent of Gross Income Derived from Institutional Commissions and Total Capital, Calendar Year 1968	2237
XIII-53	Distribution of Broker-Dealers by Percent of Gross Income Derived from Institutional Commissions and Total Gross Income, Calendar Year 1968	2238
XIII-54	Institutional Investors OTC Net Trades in Stock with Broker-Dealers, 1968	2241
XIII-55	Institutional Investors Number of Broker-Dealers Having OTC Net Trades with Institutions, 1968	2242
XIII-56	Concentration of OTC Net Trades with Broker-Dealers by Institutional Investors, Calendar Year 1968	2243
XIII-57	Broker-Dealer OTC Net Trades in Stocks with Institutions, Calendar Year 1968	2244
XIII-58	Distribution of Broker-Dealers by OTC Net Trades in Stocks with Institutional Investors and Exchange Membership, Calendar Year 1968	2245

Table No.		Page
XIII-59	Distribution of Broker-Dealers by OTC Net Trades in Stocks with Institutional Investors and Total Capital Calendar Year 1968	2246
XIII-60	Distribution of Broker-Dealers by OTC Net Trades in Stocks with Institutional Investors and Total Gross Income, Calendar Year 1968	2247
XIII-61	Fifty Broker-Dealers' with Greatest Volume of OTC Net Trades in Stocks with Institutions, Calendar Year 1968	2248
XIII-62	Customer Designation of Broker-Dealers, Bank and Investment Adviser Managed Accounts	2251
XIII-63	Commissions Paid by Banks to Broker-Dealers Designated by Bank Customers, by Customer, Designated Commissions as a Percent of Total Commissions, Calendar Year 1968	2252
XIII-64	Commissions Received by Broker-Dealers from Banks Upon Customer Designation, as a Percent of Total Commissions Received from Banks, Calendar Year 1968	2253
XIII-65	Commissions Received by Designated Broker-Dealers from 41 Banks, Calendar Year 1968	2254
XIII-66	Distribution of Share Size of Orders to Purchase or Sell Stocks, NYSE Members, 1969	2262
XIII-67	Commissions Paid by Banks for Research, by Research Commissions as a Percent of Free Commissions, Calendar Year 1968	2266
XIII-68	Commissions Paid by Advisers to Investment Company Complexes, by Research Commissions as a Percent of Total Commissions, Calendar Year 1968	2267
XIII-69	Number of Broker-Dealers Paid Commissions for Research, 1968	2268
XIII-70	Commissions Received by Broker-Dealers for Research from Investment Company Complexes, Calendar Year 1968	2269
XIII-71	Commissions Received by Broker-Dealers for Research from Banks, Calendar Year 1968	2270
XIII-72	Research Expenses by Commission Income Per Transaction, NYSE Member Firms, 1968	2271
XIII-73	Security Commission Research Expenses as a Percent of Total Expenses, by Commission Income Per Transaction, NYSE Member Firms, 1968	2272
XIII-74	Margin Trading—All Markets Relative Importance of Customer Groups, 1969	2275
XIII-75	Institutional Investors, Number of Broker-Dealers with Whom They Have Direct Wires, 1968	2276
XIII-76	Percent of Broker-Dealers Receiving Actual and Imputed Free Commissions Who Were Bank Depositors, Banks, Calendar Year 1968	2287
XIII-77	Percent of Actual and Imputed Free Commissions Paid to Depositors, Calendar Year 1968	2288
XIII-78	Percent of Depositors Receiving Free Commissions, 43 Banks, Calendar Year 1968	2289
XIII-79	Number of Banks Where Individual Broker-Dealers Had Demand Deposit Accounts or Loans Outstanding, January 1, 1968–June 30, 1969	2290
XIII-80	Bank Brokerage Commissions as a Percent of Broker-Dealer Bank Deposits, Calendar Year 1968	2291
XIII-81	Percent of Commission Recipients That Sold Shares of the Funds from Which the Commissions Were Received, Calendar Year 1968	2292
XIII-82	Percent of Fund Sellers Paid Commissions by the Investment Companies Whose Shares They Sold, Calendar Year 1968	2293
XIII-83	Percent of Actual and Imputed Investment Company Commissions Paid to Sellers of Fund Shares, Calendar Year 1968	2294
XIII-84	Mutual Fund Sales, NYSE Members And Total Fund Sales, 1962–1969	2295
XIII-85	Fees for Account Supervision, Investment Advisory and Administrative Services, New York Stock Exchange Member Firms, 1969	2301

Table No.		Page
XIII-86	Fees for Account Supervision and Investment Advice New York Stock Exchange Member Firms, 1962-1969	2302
XIII-87	Fees for Account Supervision and Investment Advice Relative to Security Commission Income New York Stock Exchange Member Firms, 1962-1969	2303

CHAPTER XIII

IMPACT OF INSTITUTIONAL TRADING ON BROKERAGE SERVICES AND THE SECURITIES INDUSTRY

A. INTRODUCTION

1. Scope of Chapter

This chapter deals with both the relationship of institutional investors to the securities industry and the impact of that relationship over time. For purposes of this chapter the securities industry includes those persons and firms that meet the statutory definition of "broker" or "dealer." The Securities Exchange Act defines a broker as: "any person engaged in the business of effecting transactions in securities for the account of others. . . ." [1]

A dealer is defined as: "any person engaged in the business of buying and selling securities for his own account but does not include . . . any person insofar as he buys or sells securities for his own account . . . but not as a part of a regular business." [2]

Brokers normally receive a commission for acting as agent for others in the execution of securities transactions. Dealers normally attempt to profit on principal transactions with others. Compensation for the actual execution of securities transactions represents only a minor part of the payments made by institutional investors to broker-dealers. The first part of the chapter deals with the impact of the growth of institutional equity investment on the securities industry during the 1960's. Both the period before and after changes in stock exchange rules on the level, structure and sharing of commissions took effect were studied in detail. The second part of this chapter will be devoted to a discussion of those other services for which payments are made and their importance to both the institutional investors and the broker-dealers. The third part of the chapter analyzes the question of institutional affiliations with broker-dealers.

2. Sources of Data

The major sources of quantitative data used in this chapter are three Study questionnaires, Forms I–7, I–29 and I–61, and the Income and Expense Reports of New York Stock Exchange (NYSE) member firms. Much of the descriptive material comes from interviews conducted by the Study as well as the transcript of proceedings before the Commission, In the Matter of SEC Rate Structure Investigation of National Securities Exchanges (SEC Rate Hearings).

[1] Securities Exchange Act, sec. 3(a)(4).
[2] Securities Exchange Act, sec. 3(a)(5).

Form I–7, sent to 227 institutional investors, collected data on the commissions paid by these institutions and the volume of their principal transactions in stocks for the calendar year 1968 and for the first six months of 1969. Data were collected for both their total dealings and their dealings with a sample of broker-dealers.[3]

In addition to data on total commissions, figures were provided detailing the amount of commissions designated by customers, the amount of commissions paid and/or directed for research, and the prevalence of institutions receiving such services as custody of securities, portfolio valuation or direct wires from broker-dealers. Responses were received from 49 banks, 26 life insurance companies, 21 property and casualty insurance companies, 13 self-administered pension funds, 10 self-administered foundations, and 17 self-administered college endowments. These were the largest institutions in each category in terms of assets. In addition, data were collected from the 88 largest investment advisers on their registered investment company and other accounts.[4] Although in most instances the advisers were unable to supply data on accounts other than registered investment companies, data were available for the investment companies managed by 57 of these advisers and the other accounts of 36 of the advisers. The data were available for all of the 10 largest registered investment company complexes, but only for the non-investment company accounts of two of the 10 largest advisers to such accounts.

Form I–29 was sent to the same institutional investors as Form I–7. This form asked about certain trading procedures used by these investors in the purchase and sale of stock, the responsibilities and makeup of the trading department, the discretion given to broker-dealers, the policy on combining orders of two or more accounts, the use of market-makers as opposed to agents and the extent that the institution dealt directly with other institutions or the issuer of the stock.

Form I–61 was sent to both a random and selected sample of broker-dealers.[5] The random sample initially consisted of 10 percent of all broker-dealers registered with the Commission. From this list the Study selected all broker-dealers that reported upon registration with the Commission that they intended to, or already did, earn at least 10 percent of their gross income from any of the following three capacities:

(1) "exchange member engaged in exchange commission business";

(2) "broker or dealer retailing corporate securities over-the-counter"; or

(3) "broker or dealer making inter-dealer over-the-counter markets in corporate securities."[6] Only firms which acted in at least one of these three capacities were likely to receive any significant institutional business in stocks. Some firms which received the questionnaire

---

[3] These were the same broker-dealers in the Form I–61 sample described below.

[4] These include most investment advisers managing over $100 million of assets whether or not registered under the Investment Advisers Act of 1940.

[5] The names of the sampled broker-dealers are contained in Lists F and G in Supplementary Volume II.

[6] This information is requested by question 22 of Form BD. Since the registration form was revised in September 1968, and all broker-dealers were required to file the revised form, the classification of firms on this basis was in almost every instance based on current data about the firm.

were excused when it was learned that, although they intended to engage in these activities, they had never actually done so. Others were excused because they had either ceased business prior to the period studied or had not initiated business until after the period studied. Data from 210 of the broker-dealers chosen at random were used in the analysis. Additional firms were chosen if they were known to be major institutional brokers, block positioners or institutional research firms, or if they had some other characteristic of interest. Responses from 85 of these selected brokers were used in the analysis.

Form I–61 asked for data from these broker-dealers about their exchange memberships held, their sources of income, their dealings as market-makers and block positioners, their other principal transactions, their capital and their personnel. One schedule included summary information on their banking relationships with all banks and detailed information on their relationships with the 50 banks in the sample for Form I–7. Another schedule dealt with their total mutual fund sales and their sales of the funds managed by the investment advisers in that sample.[7]

Members of the NYSE doing business with the public file an annual report with that exchange which details the income, expenses and capital of the firm. Reports filed for the years 1962 through 1969 were used extensively in studying the long term trends in the securities industry. In addition, certain analyses of the Income and Expense Reports and related data done for the NYSE by the National Economic Research Associates (NERA) have been used. The use of Income and Expense data as a measure of absolute income, expenses and profits has been questioned since the industry does not have a uniform system of accounts, and the profits of the commission and other parts of the business are in part determined by the allocation of expenses in a manner which is not necessarily consistent among respondents.[8] Consequently, these reports and the NERA analyses were used in the context of this Study only to show trends over periods of time or to compare one type of firm against another and not to ascertain absolute magnitudes. Since allocations are presumably made consistently over time by individual firms, and there is no reason to assume any differences among different types of firms in their methods of allocation, the data were appropriate at least for this limited use.

On July 1, 1968, the Commission commenced its rate hearings. These hearings, which have continued intermittently for more than two years, have produced more than 7,000 pages of transcript and hundreds of exhibits. Witnesses appeared representing the self-regulatory bodies, broker-dealers, institutional investors, the AntiTrust Division of the Department of Justice and other interested parties. The transcript and exhibits have served as a source for some of the material in this chapter.

In addition, the Study interviewed hundreds of people, including broker-dealers, bankers, insurers, investment advisers and managers of foundations, pension funds and endowments.

---

[7] The names of the banks and the mutual funds for which these data were collected appear in Lists N and O, respectively.

[8] For a more complete description of the Income and Expense Reports and some of their deficiencies. See In the Matter of SEC Rate Structure Investigation of National Securities Exchanges, Commission file No. 4–144 ("SEC Rate Hearings"), at 4189–4194. On October 22, 1970, the Commission requested the NYSE to develop and submit a plan by May 31, 1971, for a uniform system of accounts and uniform methods of cost allocation. See Securities Exchange Act Release No. 9007.

B. LONG-TERM IMPACT OF INSTITUTIONAL INVESTORS ON THE SECURITIES INDUSTRY

1. Overall Trends in the Securities Industry

The 1960's saw dramatic change in the securities industry. Between 1960 and 1968 total dollar volume of stocks traded on the NYSE rose from $38.0 billion to $145.0 billion, and volume of the American Stock Exchange increased from $4.2 billion to $34.8 billion. Similarly, volume on the regional exchanges increased from $3.1 billion to $16.6 billion by the end of 1968. This 334 percent increase in the dollar value of trading volume on all registered exchanges, combined with increases in over-the-counter trading, mutual fund sales, and sales of underwritten issues produced tremendous growth in the securities industry.[9]

Table XIII–1 shows for one segment of the industry—NYSE member firms doing business with the public—the distribution of gross income for the period 1962 to 1968. During this period the gross income of these firms increased about 270 percent, from under $1.5 billion to more than $5.4 billion. In 1962 more than a third of the member firms reported gross income of under $1 million and less than 1 percent reported income of at least $50 million. By 1968 only 7 percent of the firms reported gross income under $1 million, while more than 6 percent reported gross income of $50 million or more. Table XIII–2 shows the rates of growth of various segments of these members' business. Security commission income increased 279 percent between 1962 and 1968, and gross income from all other sources increased 259 percent. The greatest percentage increase occurred in profits from trading and arbitrage (397 percent) and investments (787 percent), although this increase in part reflects differences in market conditions prevailing in 1962 and 1968. Gross interest received on customers' margin accounts increased 133 percent, but since the volume of margin debt on which the interest was earned increased only 62 percent from 1962 much of the total increase reflects a higher rate of interest charged on margin loans.

The major source of NYSE member firms' income is commissions charged on the execution of agency orders. Table XIII–3 shows, for NYSE member firms, the amount and distribution of gross commissions received for the period 1962–1968. Throughout this period commission income as a percentage of total gross income of all firms remained around 60 percent. Firms reporting gross commission income of under $1 million decreased from 55 percent of the total firms in 1962 to 17 percent in 1968. At the other extreme, firms with $25 million or more in gross commission income rose from less than 1 percent of the total firms to almost 8 percent.

Along with this higher volume of commissions and other income, member firms enjoyed correspondingly greater profits. Tables XIII–4 and XIII–5 show, for NYSE member firms, the amount and distribution of pre-tax profits on total business and security commission business.[10]

---

[9] Secs. B.7 and B.8, below, discuss the period 1960–1970 in detail.

[10] Since NYSE member firms include both partnerships and corporations, imputed rather than actal salaries of general partners and voting stockholders have been used in the Income and Expense Reports in the calculation of pre-tax profits.

Pre-tax profits on total business increased from $108 million in 1962 to more than $1 billion in 1968. The median firm in 1962 earned about $62,000 before income taxes. By 1968 the pre-tax profits of the median firm had risen to more than $500,000. The percentage of firms losing money declined from 30.6 percent to 2.6 percent.

Pre-tax profits on commission business during this period increased from $7 million to $320 million. In 1962, 59 percent of the firms reported losing money on this segment of their business; by 1968 only 17 percent lost money. Between 1962 and 1968 the percentage of firms with pre-tax profits of $1 million or more rose from 3 percent to 22 percent of the total (Table XIII–5).

XIII-1

Gross Income
New York Stock Exchange Member Firms

1962 - 1968

Gross Income ($ millions)	Percent of Firms 1962	1964	1966	1968
under 1	34.1%	24.5%	16.8%	7.0%
1- 3	37.3%	38.7%	38.1%	24.1%
3- 5	10.1%	14.2%	14.6%	15.8%
5-10	9.0%	11.3%	15.7%	23.6%
10-20	5.2%	1.9%	6.8%	15.0%
20-50	3.8%	5.2%	5.1%	8.3%
50 and over	0.6%	1.0%	3.0%	6.2%
TOTAL	100.0%	100.0%	100.0%	100.0%
Gross Income (millions)	$1,464	$1,801	$2,849	$5,403

Source: NYSE Member Firm Income & Expense Reports - various years.

TABLE XIII-2

Sources of Income
New York Stock Exchange Members
1962-1968

	INCOME ($ millions)				Percent Increase 1962-1968
	1962	1964	1966	1968	
Security commission	856	1054	1766	3246	279
Profit from trading and arbitrage	129	150	186	641	397
Profit from underwriting syndicates & selling groups	122	123	208	462	279
Profit from investments	15	32	34	133	787
Dividends and interest received by reporting firm on investments	32	40	61	55	72
Income from sales of mutual fund shares to customers at retail or to broker-dealers at wholesale	34	39	84	157	362
Fees for account supervision - investment advice	11	12	19	29	164
Interest (gross) received on customers' accounts	191	263	337	445	133
All other income	74	88	156	237	220
TOTAL GROSS INCOME	1464	1801	2851	5430	269

Source: NYSE Member Firm Income & Expense Reports - various years.

XIII-3

Gross Commission Income

New York Stock Exchange Member Firms
1962 - 1968

Gross Commission Income ($ millions)	Percent of Firms			
	1962	1964	1966	1968
under 1	54.6%	43.2%	32.3%	17.1%
1- 3	28.0%	32.6%	36.1%	32.9%
3- 5	6.9%	10.0%	11.1%	15.0%
5-10	5.8%	8.1%	10.8%	14.8%
10-25	3.8%	3.9%	5.7%	12.7%
25 and over	0.6%	2.3%	4.0%	7.5%
TOTAL	100.0%	100.0%	100.0%	100.0%
Gross Commission Income 1/ (millions)	$856	$1,054	$1,755	$3,245

1/ Includes some double counting to the extent that commissions were paid by one member to another in the form of floor brokerage, give-ups, etc. The overstatement is probably less than 10 percent of the total.

Source: NYSE Member Firm Income & Expense Reports - various years.

XIII-4

Pre-Tax Profit-Total Business

New York Stock Exchange Member Firms
1962 - 1968

Pre-Tax Profit Total Business ($ thousands)	Percent of Firms			
	1962	1964	1966	1968
Loss	30.6%	4.2%	10.0%	2.6%
Under 250	43.9%	51.0%	36.1%	17.1%
250-500	11.8%	18.1%	17.5%	16.1%
500-1,000	6.1%	11.0%	14.3%	19.2%
1,000-5,000	6.4%	13.2%	17.5%	33.4%
5,000 and over	1.2%	2.6%	4.6%	11.7%
TOTAL	100.0%	100.0%	100.0%	100.0%
Pre-Tax Profit (Loss) (millions)	$108	$239	$447	$1,013

Source: NYSE Member Firms Income & Expense Reports - various years.

XIII-5

Pre-Tax Profit-Commission Business

New York Stock Exchange Member Firms
1962 - 1968

Pre-Tax Profit Commission Business ($ thousands)	Percent of Firms			
	1962	1964	1966	1968
Loss	59.2%	34.5%	22.1%	17.1%
under 250	30.1%	45.2%	39.1%	27.7%
250- 500	4.6%	6.1%	18.1%	16.6%
500-1,000	2.9%	7.7%	8.6%	16.3%
1,000-5,000	2.9%	5.8%	11.3%	18.9%
5,000 and over	0.3%	0.3%	0.8%	3.4%
TOTAL	100.0%	100.0%	100.0%	100.0%
Pre-Tax Profit (Loss) (millions)	$7	$75	$190	$320

Source: NYSE Member Firms Income & Expense Reports - various years.

2. Growth in Institutional Investor Payments to the Securities Industry

During the 1960's the volume of institutional trading rose dramatically. On the NYSE alone, estimated share volume of institutional investors rose from about 360 million shares, or 28 percent of 1960 total public volume, to almost 2.3 billion shares, or more than 50 percent of 1969 public volume. Table XIII–6 shows, for major classes of institutional investors, their estimated share volume and their percentage of total NYSE public volume for the years 1960, 1963, 1966 and 1969.[11] On an absolute basis, institutional investor share volume during this period increased 548 percent while individual investor share volume increased only 133 percent. Between 1960 and 1969 volume generated by each type of institutional investor also increased. The two largest groups, banks and mutual funds, accounted for a combined 231 million shares in 1960 and 1.5 billion shares in 1969. Their volume increased from 18.3 to 34.0 percent of total public volume during this period.

During most of this period the average price per share traded also increased. For the full year 1960 the average price per share traded was $39.60. The average price rose to a high of $44.70 in 1966, settling to $40.80 in 1969. The average price per share traded by institutional investors has been higher than the average price of shares traded by individuals. In their Public Transaction Study conducted in 1969 the NYSE found the average price of a share traded by institutions and intermediaries was $44 and by individuals was $35. Similar price differentials have also been found in preceding NYSE Public Transaction Studies.[12]

The increase in institutional investor share volume was implemented by a substantial increase in the average size of institutional orders.[13] Between 1960 and 1969, increases in the average size of institutional orders executed on the NYSE ranged from 179 percent for self-administered pension funds to 577 percent for mutual funds. Table XIII–7 shows, for selected classes of institutional investors, the average size of orders executed on the NYSE in the period 1960 to 1969. In 1960 the average size of institutional orders ranged from a low of 166 shares for commercial banks and trust companies to a high of 550 shares for mutual funds. By 1969 the average size order for these two institutional types increased to 493 shares and 3,726 shares, respectively.

---

[11] Public share volume excludes all trading by NYSE members for their own account.

[12] For instance in 1966 the average price of shares traded by institutions and individuals was $46 and $38, respectively.

[13] For this purpose an order is defined as all purchases or sales for one brokerage account of a single security on the same day pursuant to a single order.

TABLE XIII-6

Estimated Shares Volume on the NYSE
Institutional and Individual Investors

1960 - 1969

INVESTOR TYPE	1960		1963		1966		1969	
	Shares (millions)	% of Public Volume	Shares (millions)	% of Public Volume	Shares (millions)	% of Public Volume	Shares (millions)	% of Public Volume
Commercial Bank or Trust Companies	165	12.8	224	11.6	508	16.7	949	21.1
Mutual Funds	71	5.5	107	5.5	337	11.1	584	12.9
Life Insurance Companies	9	0.7	14	0.7	34	1.1	71	1.6
Non-Life Insurance Companies	13	1.0	17	0.9	37	1.2	53	1.2
Non-Bank Trust or Estates	18	1.4	29	1.5	51	1.7	91	2.0
Self-Administered Private Pension Funds	19	1.5	21	1.1	52	1.7	126	2.8
Other Institutions	66	5.1	119	6.2	212	7.0	458	10.2
SUBTOTAL	360	27.9	529	27.4	1,230	40.4	2,332	51.8
Individuals and Non-Member Broker-Dealers	932	72.1	1,399	72.6	1,814	59.6	2,173	48.2
TOTAL	1,292	100.0	1,928	100.0	3,044	100.0	4,505	100.0

SOURCES: Public volume derived from twice reported round-lot volume plus public customer odd-lot volume minus member trading volume. Percent of public volume derived from NYSE Public Transaction Studies.

TABLE XIII-7

Average Share Size of Order Executed on NYSE
By Selected Institutions

	1960	1963	1966	1969	Percent Increase 1960-1969
Commercial Bank or Trust Company	166	205	288	493	197
Mutual Fund	550	1,148	1,730	3,726	577
Life Insurance Co.	371	570	760	1,935	422
Non-Life Insurance Co.	347	542	953	988	185
Non-Insured Private Pension Fund (Self-Administered)	350	309	366	976	179

SOURCES: New York Stock Exchange Public Transaction Studies: various years.

53-940 O - 71 - pt. 4 - 50

3. Impact of Increased Institutional Investor Business on Securities Industry Profitability

a. *Total business*

The overall increase in total business, as well as commission business, had a positive impact on the profitability of most NYSE member firms. Broker-dealers executing orders primarily for institutional investors, however, were more profitable than those broker-dealers who dealt primarily with individuals.

In order to study the relative profitability of firms, broker-dealers were grouped into institutional and individual or retail firms. This was done by using the average commission income received per transaction as a proxy for the mix of institutional and individual business of the broker-dealer. The commission on an average 100 share order during this period was about $40. Any broker-dealer with average commission income per transaction around that figure probably handled a predominant number of orders for individual rather than institutional investors. Conversely, a firm with income per transaction of three and four times the commission on a typical 100 share order probably handled a greater amount of the larger orders typically associated with institutional rather than individual investors. Firms with average commission incomes between $50 and $100 may be dealing with wealthier individuals or may have a product mix combining both institutional and individual orders, with neither type dominating.

Table XIII–8 shows, for NYSE member firms so grouped, the pre-tax profits on their total business. Although broker-dealers who dealt primarily with individuals (commission income of under $50 per transaction) accounted for 62 percent of the NYSE member firms, they accounted for 72 percent of the firms with pre-tax profits of less than $1 million, and only 41 percent of those earning more than $5 million. The institutional firms (commission income per transaction of $100 and over), although accounting for 13 percent of all firms, accounted for only 7 percent of firms with under $1 million in profits and 52 percent of those earning $5 million or more.

Table XIII–9 shows the median pre-tax profits of each class of firms. The median pre-tax profit for all NYSE member firms in 1968 was $824,000. The medians for the retail firms and the institutional firms were $672,000 and $2.4 million, respectively. Although on average the institutional firms may be larger than the retail firms it does not account for the disparity in income.

Table XIII–10 shows the pre-tax return on capital for the total business of these firms in 1968. Including those firms suffering losses, 22 percent of the retail firms, but only 10 percent of the institutional firms, had pre-tax returns of under 10 percent. At the other extreme, one-fourth of the institutional firms, but only 5 percent of the retail firms, had returns of more than 50 percent. The median pre-tax return on capital for retail firms was 18.9 percent and for institutional firms was 35.7 percent.

b. *Security commission business*

The difference in the profitability of handling the commission business of individuals as opposed to institutions was primarily responsible for the unequal distribution of total net income among member firms in 1968. Although those firms executing orders primarily for individ-

uals represent 62.4 percent of the firms and received 66.7 percent of security commission gross income, they accounted for only 32 percent of the pre-tax profit. With the largest firm doing primarily a public retail business removed from both the group of firms doing an individual business and from all firms, the gross commission income of the remaining primarily retail firms declines to 63.8 percent of total business and their percentage of total profit declines to less than 25 percent of total member pre-tax profit.

The institutional firms, although accounting for only about 13 percent of all firms and 14 percent of all commission income, accounted for 39 percent of the profits from securities commission income. If the largest retail firm is excluded from the group of firms doing primarily an individual business and from the total, the institutional firms' share of the remaining profits rises to 43 percent.

Table XIII–11 shows that the groups of firms with higher pre-tax profits have higher median commission income per transaction. Table XIII–9 shows that the median profit for the 241 firms doing primarily a retail business was $182,000, while the median profit for the institutional firms was more than $1 million. Table XIII–11 shows that firms suffering losses on commission business had a median commission income per transaction of $38.63, while firms with profits of $500,000 to $1 million had median income per transaction of $52.56. For the firms with profits of $5 million to $10 million, and $10 million and over, the median commission income per transaction was $99.66 and $191.37, respectively. Ninety-two percent of the firms that lost money on their commission business were retail firms while only one of the institutional firms suffered a loss. At the other extreme, of the 13 firms with profits of $5 million or more, three were in the retail category and seven were in the institutional category.

Similarly, the pre-tax profit margins, that is, pre-tax profit as a percent of total gross income, of institutional firms were considerably higher than those of the retail firms. For the entire categories of retail and institutional firms, profits were equal to 4.8 percent and 26.8 percent, respectively, of gross commission income.[14] As shown in Table XIII–12 the median profit margin of the retail firms was 6.6 percent, and the median of the institutional firms was 26.7 percent.

The higher profits for institutional firms cannot be attributed solely to their larger average size. The median institutional firm had total gross commission income of $4.3 million, compared with $2.9 million for the retail firms. Table XIII–13 shows that the median profit margin of the institutional firms grouped by size classes was in every case greater than the median for retail firms in the same size class.

The higher profit margins of institutional firms were attributable to a commission rate schedule which did not recognize any of the economies in handling larger orders.[15] Although detailed data on the cost of handling different size transactions are not available for 1968, such data are available for 1969. According to a study done for the

[14] The Income and Expense Reports, on which these profit margin calculations are based, include in gross income receipts of give-ups and do not exclude payments of give-ups. Institutional firms paying give-ups reflect such payments as an expense. In calculating profit margin if gross income were stated as net of give-ups paid, and such payments were not stated as an expense, the disparity between retail and institutional firm profit margins would be greater. For a discussion of give-ups see sec. C.4, below.

[15] Although the rate structure did not recognize any economies in handling larger orders the firms handling these orders often gave-up part of the commissions received on these transactions to other broker-dealers. See sec. C.4, below.

NYSE,[16] the average cost of handling a 1,000 share, a 10,000 share and a 100,000 share order of a $40 stock in 1969 was respectively, about 6, 42 and 377 times as great as the average cost of handling a 100 share order, yet the commission charged in 1968 was, respectively, 10, 100 and 1,000 times the 100 share commission.[17] As shown on Table XIII-14, the rate schedule in effect prior to December 5, 1968, resulted in the profit per order increasing with the size of orders. Added to the economies resulting from the increased size of orders were any economies individual firms enjoyed from the overall increase in the volume of business during the 1960s.

c. *Other business*

Aside from the execution of agency orders, NYSE members received income from various other sources. The three most important by amount of gross income to members as a group were trading and arbitrage, underwriting, and margin interest income. For all firms these three accounted for $641 million, $462 million and $445 million, respectively. Income from these sources accounted for 29 percent of total gross income and 71 percent of income from sources other than commissions.

The type of other business done by any particular firm is closely related to the type of customer it deals with in its commission business. For instance, retail firms derived more than 10 percent of their other income from the sale of mutual fund shares, while institutional firms received only four-tenths of 1 percent of their other business from this source (Table XIII-15). Likewise, interest received on customer accounts (margin interest income) accounted for 29 percent of the retail firms total other income but less than 4 percent of the other income of institutional firms.

Profits from other than commissions are shown in Table XIII-16. Unlike the situation with the commission income figures, the percentage of institutional firms losing money on other business was greater than the percentage of retail firms losing money. The median pre-tax profit on this other business was greater for the institutional firms. On average, however, they are larger firms.

The more profitable commission business done by the institutional firms may in certain instances be offset by losses suffered on the other business. For example, at least some block positioners regularly incur trading losses on their positions in order to attract the highly profitable institutional commission business.[18] Similarly, interviews indicate that some broker-dealers making a market in over-the-counter securities at times engage in principal transactions with the institutional commission customers at lower markups than would have been prescribed were the transactions in the regular course of market-making. For instance, one institutional brokerage house reported that it was in their best long-range interest to buy from its regular institutional customers shares in which it was a market-maker close to or at the last sale even though the heavy volume of their sales might have resulted in much lower prices.

---

[16] NERA, *Stock Brokerage Commissions: The Development and Application of Standards of Reasonableness for Public Rates* (July 1970).
[17] These relative costs would be slightly different if an adjustment for the cost of margin orders had not been made by NERA.
[18] See ch. XII for a discussion of block positioning.

TABLE XIII-8

Pre-Tax Profit-Total Business
By Commission Income Per Transaction
NYSE Member Firms
1968

(a)

Commission Income Per Transactions (dollars)	PRE-TAX PROFIT-TOTAL BUSINESS ($000)							
	Loss	Under 250	250 to 500	500 to 1000	1000 to 5000	5000 to 10000	10000 and Over	TOTAL
Under 50	3.3	19.5	18.7	22.0	29.0	3.3	4.1	100.0
50 - 100	2.2	17.2	14.0	9.7	46.2	4.3	6.5	100.0
100 and over		7.7	5.8	23.1	30.8	15.4	17.3	100.0
ALL FIRMS	2.6	17.4	15.8	19.2	33.4	5.2	6.5	100.0

(b)

Commission Income Per Transactions (dollars)	PRE-TAX PROFIT-TOTAL BUSINESS ($000)							
	Loss	Under 250	250 to 500	500 to 1000	1000 to 5000	5000 to 10000	10000 and Over	TOTAL
Under 50	80.0	70.1	73.8	71.6	54.3	40.0	40.0	62.4
50 - 100	20.0	23.9	21.3	12.2	33.3	20.0	24.0	24.1
100 and over		6.0	4.9	16.2	12.4	40.0	36.0	13.5
ALL FIRMS	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: NYSE Member Firm Income & Expense Reports: 1968

TABLE XIII-9

Median Pre-Tax Profits
By Commission Income Per Transaction
New York Stock Exchange Member Firms
1968

Commission Income Per Transaction (dollars)	Median Pre-Tax Profit ($ thousands)		
	Commission Business	Other Business	Total Business
under 50	182	418	672
50 to 100	524	543	1,194
100 and over	1,038	656	2,421
all firms	309	478	824

Source: NYSE Member Firm Income & Expense Reports : 1968

TABLE XIII-10

Pre-Tax Return on Capital-Total Business
By Commission Income Per Transaction
NYSE Member Firms
1968

(a)

Commission Income Per Transactions (dollars)	Return on Capital-Total Business							
	Loss	Under 10	10 to 20	20 to 30	30 to 40	40 to 50	50 to 70	70 and over	Total
Under 50	3.3	19.1	32.0	18.7	16.2	6.2	4.6		100.0
50 - 100	2.2	12.9	28.0	24.7	11.8	8.6	6.5	5.4	100.0
100 and over		9.6	9.6	21.2	15.4	19.2	11.5	13.5	100.0
TOTAL	2.6	16.3	28.0	20.7	15.0	8.5	6.0	3.1	100.0

(b)

Commission Income Per Transactions (dollars)	Return on Capital-Total Business							
	Loss	Under 10	10 to 20	20 to 30	30 to 40	40 to 50	50 to 70	70 and over	Total
Under 50	80.0	73.0	71.3	56.3	67.2	45.5	47.8		62.4
50 - 100	20.0	19.0	24.1	28.8	19.0	24.2	26.1	41.7	24.1
100 and over		7.9	4.6	13.8	13.8	30.3	26.1	58.3	13.5
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: NYSE Member Firm Income & Expense Reports : 1968

TABLE XIII-11

Pre-Tax Profit-Commission Business
By Commission Income Per Transaction
NYSE Member Firms
1968

(a)

Commission Income Per Transactions (dollars)	PRE-TAX PROFIT-COMMISSION BUSINESS ($000)							
	Loss	Under 250	250 to 500	500 to 1000	1000 to 5000	5000 to 10000	10000 and Over	TOTAL
Under 50	25.3	31.5	17.4	11.6	12.9	0.8	0.4	100.0
50 to 100	4.3	28.0	17.2	23.7	23.7	3.2		100.0
100 and over	1.9	9.6	11.5	25.0	38.5	9.6	3.8	100.0
TOTAL	17.1	27.7	16.6	16.3	18.9	2.6	0.8	100.0
MEDIAN COMMISSION INCOME PER TRANS ($)	38.63	39.98	42.80	52.56	55.06	99.66	191.37	43.37

(b)

Commission Income Per Transactions (dollars)	PRE-TAX PROFIT-COMMISSION BUSINESS ($000)								MEDIAN PRE-TAX PROFIT-COMMISSION BUSINESS ($000)
	Loss	Under 250	250 to 500	500 to 1000	1000 to 5000	5000 to 10000	10000 AND OVER	TOTAL	
Under 50	92.4	71.0	65.6	44.4	42.5	20.0	33.3	62.4	182
50 to 100	6.1	24.3	25.0	34.9	30.1	30.0		24.1	524
100 and over	1.5	4.7	9.4	20.6	27.4	50.0	66.7	13.5	1038
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	309

Source: NYSE Member Firm Income & Expense Reports : 1968

TABLE XIII-12

Pre-Tax Profit Margin on Commission Business
By Commission Income Per Transaction
NYSE Member Firms
1968

(a)

Commission Income Per Transactions (dollars)	PRE-TAX PROFIT MARGIN ON COMMISSION BUSINESS ($000)							
	Loss	Under 5	5 to 10	10 to 15	15 to 20	20 to 25	25 and Over	TOTAL
Under 50	25.3	17.0	22.0	13.7	10.8	4.1	7.1	100.0
50 - 100	4.3	10.8	20.4	19.4	17.2	5.4	22.6	100.0
100 and over	1.9	1.9	9.6	11.5	5.8	13.5	55.8	100.0
TOTAL	17.1	13.5	19.9	14.8	11.7	5.7	17.4	100.0
MEDIAN COMMISSION INCOME PER TRANS ($)	38.63	39.29	42.69	47.60	48.53	53.20	90.37	43.37

(b)

Commission Income Per Transactions (dollars)	PRE-TAX PROFIT MARGIN ON COMMISSION BUSINESS ($000)								MEDIAN PRE-TAX PROFIT MARGIN-COMMISSION BUSINESS
	Loss	Under 5	5 to 10	10 to 15	15 to 20	20 to 25	25 and Over	TOTAL	
Under 50	92.4	78.4	68.8	57.9	57.8	45.5	25.4	62.4	6.6
50 - 100	6.1	19.6	24.7	31.6	35.6	22.7	31.3	24.1	13.8
100 and over	1.5	2.0	6.5	10.5	6.7	31.8	43.3	13.5	26.7
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	9.7

Source: NYSE Member Firm Income & Expense Reports : 1968

Table XIII-13

Median Profit Margin on Commission Business
by Commission Income Per Transaction and
Security Commission Gross Income
NYSE Member Firms
1968

Commission Income Per Transactions (dollars)	Commission Income ($millions)								
	Under 1	1 to 2	2 to 3	3 to 4	4 to 5	5 to 7	7 to 10	10 to 20	20 and over
Under 50	4.1	7.5	10.6	9.1	9.3	6.3	3.5	7.2	3.5
50 - 100	10.9	14.3	26.3	13.0	14.4	16.1	15.3	10.9	13.4
100 and over	23.2	34.3	35.5	27.8	13.5	24.8	21.2	25.4	22.5
All Firms	5.3	10.0	13.3	13.6	11.8	7.5	6.6	11.2	8.0

Note: The number in each cell is the median profit margin on commission business of all firms in that cell.

Source: NYSE Member Firm Income & Expense Reports: 1968

TABLE XIII-14
Index of Income, Costs and Profit Margin
For Various Size Orders
NYSE Member Firms
Pre-December 5, 1968

Size of Order	Index of Commission Income	Index of Average Cost 1/	Index of Profit Margin 2/
100	100.0	100.0	0.0
200	200.0	165.3	17.4
300	300.0	225.6	24.8
400	400.0	282.3	29.4
500	500.0	336.3	32.7
1000	1000.0	578.0	42.2
5000	5000.0	2180.8	56.4
10000	10000.0	4180.8	58.2
100000	100000.0	37697.4	62.3

1/ Average costs of transactions under 5000 shares include an adjustment for the cost of handling margin orders.

2/ Profit margins are based on an assumed firm whose average cost of executing a 100 share order of a $40 stock equals its pre-December 1968 income from a 100 share order.

Source: Average cost index derived from NERA Stock Brokerage Commission: The Development and Application of Standards of Reasonableness for Public Rates

Table XIII-15

SOURCES OF INCOME OTHER THAN SECURITY COMMISSIONS
NEW YORK STOCK EXCHANGE MEMBERS
1968

	Security Commission Income Per Transaction											
	Under 50			50 to 100			100 and over			All Firms		
		As a percent of Total			As a percent of Total			As a percent of Total			As a percent of Total	
	$ Millions	Other Income	Gross Income	$ Millions	Other Income	Gross Income	$ Millions	Other Income	Gross Income	$ Millions	Other Income	Gross Income
Profit or loss from trading and arbitrage	319	25.3	9.3	145	34.1	13.9	177	37.4	18.9	641	29.7	11.9
Profit or loss from Underwriting Syndicates & Selling Groups	254	20.2	7.4	102	24.0	9.8	106	22.4	11.3	462	21.4	8.6
Profit or loss from investments	379	30.1	11.1	25	5.9	2.4	70	14.8	7.5	133	6.2	2.5
Dividends and interest received by reporting firm on investments	275	2.18	8.0	9	2.1	0.9	18	3.8	1.9	55	2.6	1.0
Income from sales of mutual fund shares to customers at retail or to broker-dealers at wholesale	127	10.1	3.7	27	6.4	2.6	2	0.4	0.2	157	7.3	2.9
Fees for account supervision - investment advice	8	0.6	0.2	10	2.4	1.0	11	2.3	1.2	29	1.3	0.5
Interest (gross) received on customers' accounts	369	29.3	10.8	57	13.4	5.5	18	3.8	1.9	445	20.6	8.2
All Other Income	116	9.2	3.4	40	11.5	4.7	71	15.0	7.6	237	11.0	4.4
Total Other Income	1259	100.0	36.8	425	100.0	40.8	473	100.0	50.5	2157	100.0	39.9
Security Commission Income	2165		63.2	617		59.2	464		49.5	3246		60.1
Total Gross Income	3424		100.0	1042		100.0	937		100.0	5403		100.0

Source: NYSE Member Firm Income & Expense Reports : 1968.

TABLE XIII-16

Pre Tax Profit On Other Business
By Commission Income Per Transaction
NYSE Member Firms
1968

(a)

Commission Income Per Transaction (dollars)	PRE-TAX PROFIT ON OTHER BUSINESS ($000)							
	Loss	Under 250	250 to 500	500 to 1000	1000 to 5000	5000 to 10000	10000 and OVER	TOTAL
Under 50	3.7	32.4	17.4	16.6	24.1	1.7	4.1	100.0
50 - 100	10.8	31.2	4.3	18.3	26.9	7.5	1.1	100.0
100 and over	19.2	19.2	7.7	9.6	25.0	9.6	9.6	100.0
TOTAL	7.5	30.3	13.0	16.1	24.9	4.2	5.4	100.0
MEDIAN INCOME PER TRANS ($)								

(b)

Commission Income Per Transaction (dollars)	PRE-TAX PROFIT ON OTHER BUSINESS ($000)								MEDIAN PRE-TAX PROFIT-OTHER BUSINESS ($000)
	Loss	Under 250	250 to 500	500 to 1000	1000 to 5000	5000 to 10000	10000 and OVER	TOTAL	
Under 50	31.0	66.7	84.0	64.5	60.4	25.0	62.5	62.4	418
50 - 100	34.5	24.8	8.0	27.4	26.0	43.8	6.3	24.1	543
100 and over	34.5	8.6	8.0	8.1	13.5	31.3	31.3	13.5	656
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	

Source: NYSE Member Firm Income & Expense Reports: 1968

4. Distribution of Increased Institutional Investor Business

Because of the more profitable nature of institutional commission business during the 1960's it was widely sought by broker-dealers. Firms attempted to gain additional business by tailoring their services and advertising to the institutional investor. Conferences and seminars, where broker-dealers and institutional investors could meet, became common-place. The increased sale of mutual funds and the need for larger bank deposits resulting from increased business gave some firms additional reasons to receive institutional business.[19] The result of all this was that most NYSE member firms were affected to some extent by the increase in the percentage of the total commission business accounted for by institutions. Table XIII–17, which has been adjusted for changes in the price level per share between 1962 and 1968, shows the number of firms in seven categories of average commission income per transaction in 1962 and 1968. Of the 265 member firms in business at both the beginning and end of the period, 53 percent remained in the same category and 4 percent moved into a lower income per transaction category.[20] Forty-three percent of the firms moved into a higher income per transaction category. Of the 48 firms with income per transaction of $100 or more in 1968, only four were in that category in 1962. Eleven of the 30 firms with 1962 income per transaction of between $50 and $100 had 1968 income per transaction of at least $100.

Of the 265 firms that were in business during both years, those that moved into a higher average income per transaction category generally were able to retain their portion of the total commission income of the Exchange community, while those firms that remained in the same category saw their portion of the total decrease significantly. This is shown in Table XIII–18. Those firms with average commission income per transaction under $50 in both 1962 and 1968 saw their percentage of total commissions decline from 65.3 percent to 55.6 percent. Those firms moving from one category into a higher category of average gross income increased their share of the market from 16.9 percent to 19.3 percent. In 1962, firms with average transactions under $50 accounted for over 91 percent of total commission income, while firms with income averaging $100 and over accounted for only 1 percent of the total. By 1968 the total commission business done by firms with income per transaction under $50 had fallen to 65.6 percent of the total, while firms with income per transaction of $100 and over accounted for 14.3 percent of the total.

The period 1962 to 1968 was marked by the exit of member firms dealing primarily with the public and the entry of many new firms, including many doing an institutional business. Eighty-one firms ceased to report between 1962 and 1968, 71 with 1962 income per transaction under $50.

In 1968 there were 121 firms which had not reported in 1962. Most of these firms were either not in business in 1962, were not members of the NYSE in 1962, or if members they did not carry customer accounts but introduced their business to other members. Of these 121

[19] For a discussion of the role of reciprocity in generating business see sec. 7, below.
[20] There were many additional firms whose gross commission income per transaction increased but not enough to move them into a higher category.

firms, only 74 had average commission income in 1968 under $50, while 21 firms had income per transaction of $100 and over. Of the 27 firms handling the largest orders in 1968 (average commission income of $150 and over), 15 did not report in 1962.

Those firms reporting in 1962 but not 1968 accounted for 14.3 percent of 1962 commission income; those firms reporting in 1968 but not 1962 accounted for 21 percent of 1968 income.

Although institutional investors distributed the bulk of their commission business by placing purchase and sell orders with the broker-dealers of their choice, further redistributions were often made by directing the confirming broker-dealer, that is, the one receiving the full non-member commision, to pay a portion of the commission received to other broker-dealers. This practice, which came to be known as the "give-up", grew very rapidly during the 1960's. The two major types of give-ups were the give-up by check and the floor give-up. In the former the confirming broker-dealer (usually the executing broker) would send checks at the end of each month, (or some other period) to other broker-dealers for the amount specified by its customer. In a floor give-up the broker-dealer would execute the order but would not confirm the execution. The transaction would be confirmed by another broker-dealer that the institution would want to compensate for services unrelated to the execution. The executing broker would receive floor brokerage equal to about 10 percent of the nonmember commission for its services and if it also cleared the trade it would receive an additional 10 percent of the commission. Table XIII–19 shows the volume of investment company directed give-ups during the period 1964 to 1968.[21] This Table reflects give-ups by check. It does not include floor give-ups. In 1964, investment companies directed NYSE members to pay $11.4 million to other brokers. Of this amount, $10.4 million was from NYSE transactions, and $1 million was from commissions received on transactions on other exchanges. Between 1964 and 1968 total investment company directed give-ups by check increased more than 700 percent to $91.7 million. Give-ups on NYSE transactions increased to more than $71 millon while give-ups on all other exchanges grew to $19 million. Give-ups on over-the-counter transactions of $1.2 million were reported. The legality of such give-ups is highly questionable. Since the over-the-counter market is a negotiated market with no fixed rates of commission, the payment of any give-up is evidence that a more beneficial price for the investment company could have been negotiated.

In 1968 NYSE members gave-up by check 38 percent of the $243 million in investment company commisions they received. Table XIII–20 shows, by market, give-ups of NYSE members during that year. Greater percentages of the commission dollar were given up on transactions executed on exchanges other than New York. Of the $43 million in commissions received by NYSE members from investment companies on regional exchange transactions, $19 million or 44 percent were given-up to other broker-dealers.

Investment companies were not the only types of institutions that directed confirming broker-dealers to split their commissions with

[21] Although the term "investment company directed give-ups" is used, it is the external adviser to the investment company that directs the give-up.

others. Table XIII–21 shows, for the large institutions in the Study's sample, the number of institutions of each type directing broker-dealers to pay commissions to others and the total amount directed. It was, however, among the investment companies that one found the most widespread use of this technique for compensating broker-dealers. Ninety-six million dollars of the total 1968 commissions of $275 million paid by investment companies was given up. All but nine of the 57 advisers to investment companies used this device. Although 20 of the 48 banks reporting their 1968 commissions directed broker-dealers to share commissions, only $6.4 million of the $222 million in commisions paid by banks was given-up.[22] Other types of institutions directed lesser amounts.

NYSE members reported giving up $35.7 million in 1968 at the direction of institutions other than investment companies.

Prior to December 5, 1968, the rules of the NYSE permitted members of that exchange to give-up portions of the commission paid by a customer on orders executed on that exchange to other members. Since most institutional orders to purchase and sell stock were executed on the NYSE, a large pool of commission dollars was available to be paid to all NYSE members, not just those confirming the order. An institution could negotiate the amount of the commission to be retained by the confirming broker and the confirming broker would write a check or checks for the remainder to other members named by the institution. Willingness to give-up high percentages of the commission on institutional business, as much as 70 percent, became a competitive norm along-side the historical service competition. Indeed, the executing broker could give up as much as 90 percent to the member named by the institution by simply acting as a two dollar broker and by naming the other member as confirming and clearing agent. (Of course, the give-up recipient would have the responsibility of confirming and clearing the transaction.)

The rules on NYSE executions were too restrictive to permit as wide a distribution of commission dollars as many institutions desired. Advisers to investment companies were particularly anxious to direct dollars to non-members of the NYSE since a large amount of fund sales originated with nonmembers. One loophole arose from a clause in the NYSE Constitution which allowed members holding seats on other exchanges to charge the rates of commission prescribed by the other exchange on all transactions made on the other exchange. Not only did this permit members of the NYSE to charge commissions at the rate applicable on other exchanges where they were members, but more importantly it permitted them to share commissions in accordance with the rules of the exchange where the orders were executed. At the very least, these exchanges permitted the sharing of commissions between their members, many of whom were not members of the NYSE. Thus, executions on a regional exchange widened the potential distribution to include all members of that exchange. To facilitate the payment of commissions to certain broker-dealers, funds encouraged those broker-dealers to seek regional exchange mem-

---

[22] To the extent that some banks and other institutional investors used floor give-ups these numbers may be understated.

berships. At the SEC Rate Hearings, the Chairman of the Board of the underwriter of the funds in one of the largest complexes, testified:

> [I] have suggested to non-members of any Exchange, that they might join the Midwest and they followed my suggestion within a few months after I gave them the idea and they did join the Midwest in two cases.[23]

Certain exchanges, moreover, permitted the sharing of commissions with members of any securities exchange and members of the National Association of Securities Dealers (NASD). Since the NASD included in its membership about 3,700 broker-dealers doing business with the public, the potential distribution of commission dollars was limited solely by the opportunity to execute orders on the exchanges with the most permissive rules. Since many of the large block trading firms held multiple exchange memberships it was possible, where the other side of the transaction and the executing broker were both willing, to choose among exchanges for execution. As competition for, and use of, give-ups grew, complex arrangements evolved to bring orders to regional exchanges. One such arrangement, the "mirror trade", was often used to execute orders on the Boston and Detroit Stock Exchanges. Using this technique a customer would get an NYSE execution, but would pay a Boston or Detroit Stock Exchange commission. The mirror trade operated in the following way:

One broker-dealer, a member of the Boston Stock Exchange (BSE) but not the NYSE, would receive a purchase or sell order normally ranging between 5,000 and 50,000 shares from a mutual fund. This broker-dealer was able to find the entire other side (by either contacting the BSE specialist or other firms for whom the firm acted as two dollar broker on the floor of the BSE) in less than 5 percent of the cases.

When the broker-dealer could not find the other side to a transaction, as was usual, it would send the order, for the firm's own account, to the NYSE for execution. The moment the report of the New York execution was received, the firm would immediately buy an equivalent number of shares of stock for its own account at the same price on the BSE from the fund. In other words, the firm bought the stock on BSE at the identical price at which it sold the stock on the NYSE.

The Boston trade was then confirmed to the fund, described as a principal transaction and charging a BSE commission in accordance with that exchange's rules. The firm paid the New York broker a full NYSE commission. In accordance with the confirmation, it would receive a full BSE commission from the fund; the prices were the same, thus the commissions were the same. The fund had an execution on the BSE and the firm had an execution on the NYSE. The fund would then instruct the firm to pay 50 percent of the commission to other members of the BSE or NASD members. Under the BSE rules, a member firm could give-up 50 percent of its commission to another member or it could give-up 40 percent to an NASD member and 10 percent to a member firm. At that point since the firm had promised to give-up 50 percent of the commission paid to it but had paid a full commission to the NYSE member firm, it was out-of-pocket 50 percent of a full commission. The firm made up the deficit and earned a profit

[23] SEC Rate Hearings, at 1856–1857.

by getting unrelated business and give-ups from the NYSE member firm that had executed the order for it in New York.

Since the opportunity to execute trades on those regional exchanges which permitted give-ups to NASD members was limited by those exchanges' low volume, other more circuitous routes for the distribution of commissions developed.

Figures XIII–1 and XIII–2 show how, out of $1,000 in NYSE commissions paid by a fund, one non-NYSE broker-dealer could distribute $250 to NASD only members or to foreign broker-dealers selling shares of the fund. The non-member would tell the distributor of the fund to have 50 percent of the fund's commissions on NYSE executions given-up to an NYSE member of the non-member broker-dealer's choosing. The NYSE member receiving the give-up would, in turn, pay the full amount received to the non-member for research or other services rendered by it. The non-member would then pay half the money ($500) received to NASD only members or foreign broker-dealers chosen by the fund underwriter. Given the high fixed commission rate, everybody involved in the transaction appears to have profited. The fund underwriter was able to encourage additional fund sales by making additional payments to sellers of the fund's shares without any out-of-pocket costs. The fund was able to execute the order on the NYSE with that broker-dealer believed best capable of handling the execution. The NYSE executing broker received what it probably deemed to be fair compensation for executing the order. The NYSE member that received the give-ups received some services for which it compensated the non-member in dollars it would have never seen had it not been for the arrangement. The NASD only or foreign broker-dealer received additional compensation for the sale of funds that they might not have otherwise received. The non-member benefitted since the cost of the services rendered to the NYSE give-up recipient was less than its share.

Figure XIII-1

STAGES #1 and #2

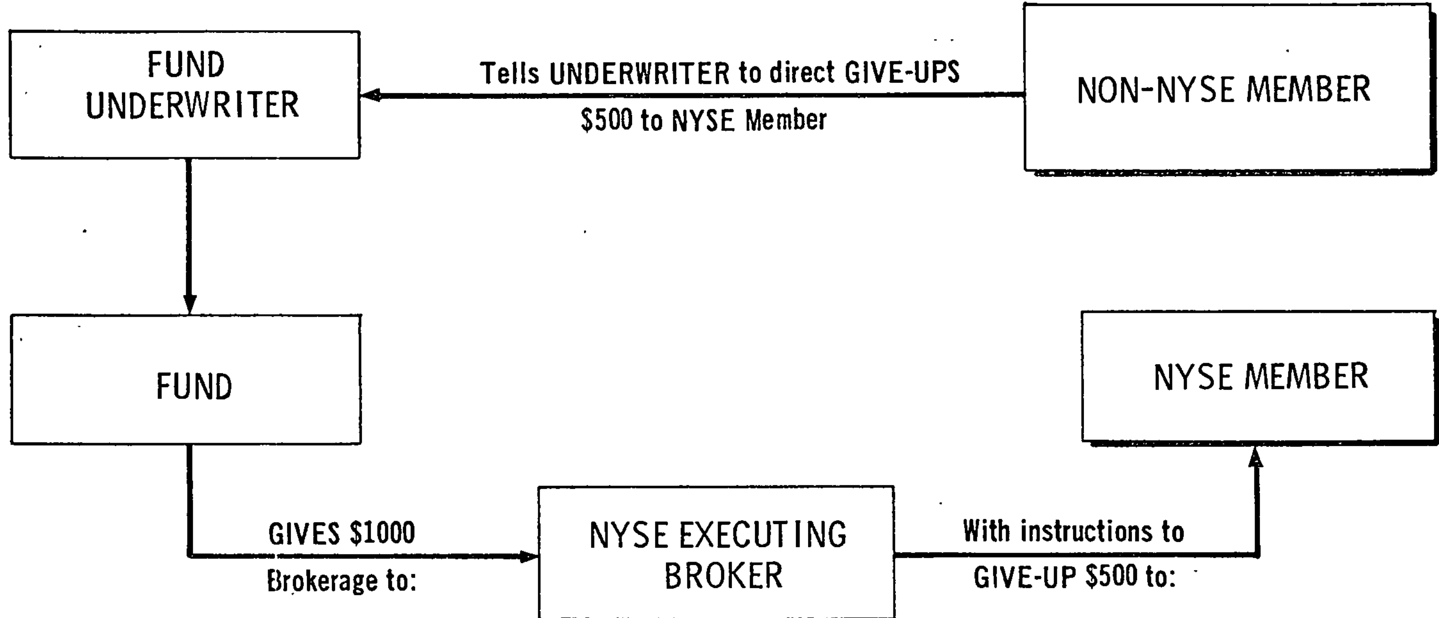
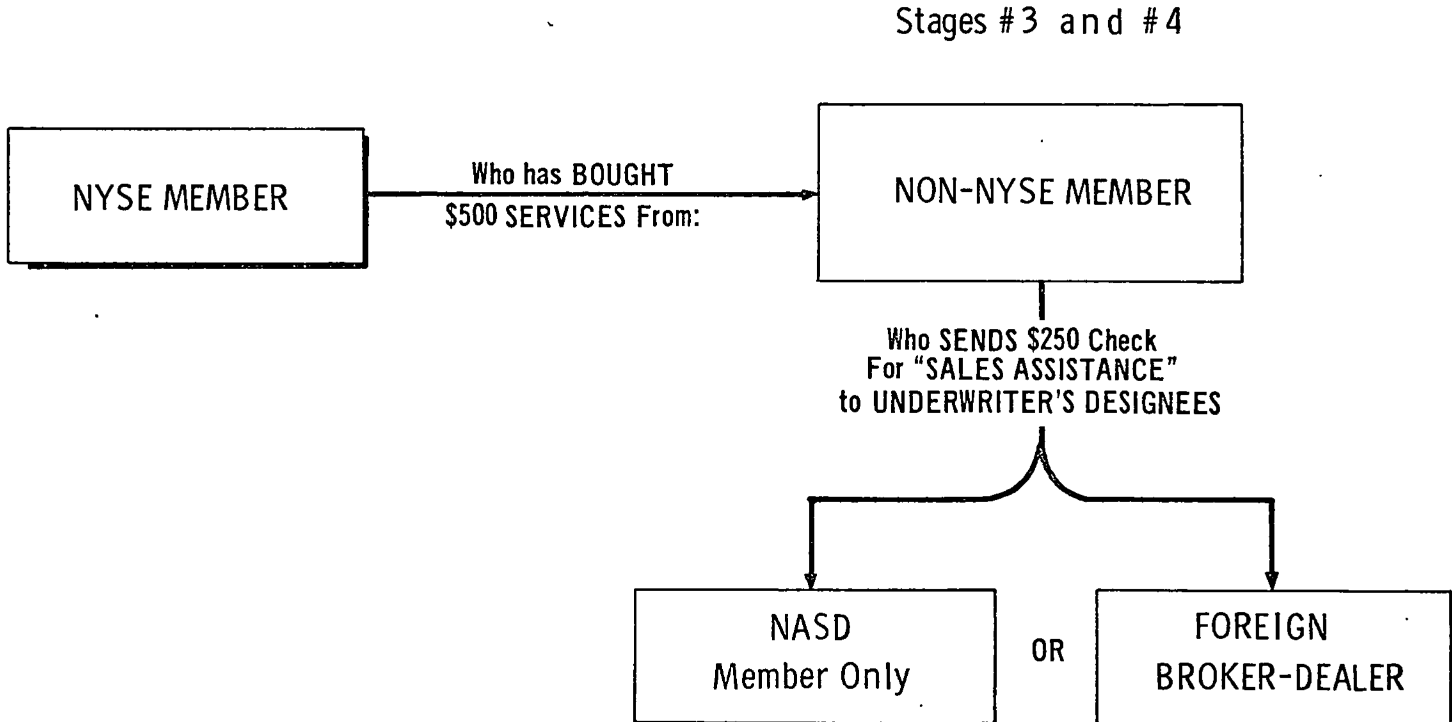


Figure XIII-2



The one common characteristic of most of these arrangements was that they permitted the institution to choose a limited number of executing broker-dealers while spreading the commissions widely. Table XIII–22 shows the percentage of NYSE member firms that were net payers and the number that were net recipients of give-ups. Between 1964 and 1968 the net payers ranged between 16.6 and 21.2 percent of NYSE firms. The net recipients, however, ranged from 59 percent to almost 66 percent of the firms.

Table XIII–23 shows the percent of NYSE member firms paying or receiving give-ups in 1968 at the direction of institutional investors. Twenty-two percent of the firms received no investment company directed give-ups and 45 percent received no directed give-ups from other institutional investors. An additional 27 percent and 29 percent, respectively, received less than $50,000 from these two sources. About 1.2 percent of the firms received more than $1 million from investment companies, and 0.8 percent received that much from other investors. Tables XIII–24 and XIII–25, respectively, show give-ups received and give-ups paid as a percent of total commissions received in 1968 from investment companies. Of the 330 firms that received some commissions from investment companies, 95 received their sole compensation in the form of give-ups, 28 receiving more than $100,000 in this manner. At the other extreme 30 firms did not receive any of their investment company commissions in the form of directed give-ups. Of the 115 firms receiving less than $100,000 from investment companies, 67 received it all in give-ups. An additional 22 received at least 60 percent of their investment company commissions in the form of give-ups. Conversely, of the 67 firms with investment company commissions of $1 million or more, 57 received less than 40 percent from give-ups.

Table XIII–25 shows the pay out rates of NYSE member firms. Of 235 firms which received commissions from investment companies, 38 paid out more than 50 percent of the total commissions received.[24] Among the largest recipients of investment company commissions the pay out ratios are the highest. Of the 56 firms receiving more than $1 million in investment company commissions, 29 percent had pay out ratios of 50 percent and higher. An additional 34 percent of the firms had pay out ratios of between 30 and 50 percent. Of the firms with investment company commissions of under $100,000 only 12 percent had pay out ratios of 50 percent and over; an additional 6 percent had pay out ratios of between 30 and 50 percent.

---

[24] Some NYSE member firms served as "conduits" in that they would pay directed give-ups from the give-ups they received from confirming brokers.

TABLE XIII-17

Average Commission Income Per Transaction
1962 and 1968
New York Stock Exchange Member Firms

Average Income Per Transaction 1962 (dollars)	Average Income Per Transaction 1968 (dollars) 1/								
	Not Reporting	Under 25	25 to 50	50 to 75	75 to 100	100 to 125	125 to 150	150 and over	TOTAL
Not Reporting		11	63	14	12	3	3	15	121
Under 25	23	19	36	6	1				85
25 to 50	48	5	121	32	7	7	1	4	225
50 to 75	7		3		6	4		2	22
75 to 100	1		1	1		2	1	2	8
100 to 125	1							3	4
125 to 150									
150 and over	1							1	2
TOTAL	81	35	224	53	26	16	5	27	467

1/ Average income per transaction for 1968 has been adjusted to reflect the change in the average price of shares traded between 1962 and 1968.

NOTE: The number in each column represents the number of firms with such available commission income in 1962 and 1968.

SOURCE: NYSE Income and Expense Reports: 1962 and 1968.

TABLE XIII-18

Percent of Total Commission
By Income Per Commission Transaction
NYSE Members
1962-1968

1962 Income Per Agency Transaction		1968 INCOME PER AGENCY TRANSACTION (DOLLARS)				
	Not Reported	Under 50	50 to 100	100 and over	TOTAL	Year
Not Reported		11.0	5.7	5.1	21.8	1968
under 50	13.7	65.3	10.9	1.5	91.4	1962
		55.6	11.4	1.7	68.7	1968
50 to 100	0.5	0.3	2.3	4.5	7.6	1962
		0.2	1.8	6.2	8.2	1968
100 and over	0.1			0.9	1.0	1962
				1.3	1.3	1968
TOTAL	14.3	65.6	13.2	6.9	100.0	1962
		66.8	18.9	14.3	100.0	1968

1/ Firms classified as not reported include firms which reported in one year, but not the other. Most firms, so classified were either not in business or, if they were in business did not carry customers' accounts, or were not members of the NYSE.

SOURCE: NYSE Member Firm Income and Expense Reports: 1962 and 1968.

TABLE XIII-19

Give-Ups Paid At the Direction of Advisers to Investment Companies
New York Stock Exchange Member Firms
1964-1968

	Give-Ups Paid to Others at the Direction of Investment Companies 1/ ($ millions)			
Year	New York Stock Exchange	Other Stock Exchanges	Over-the-Counter	TOTAL
1964	10.4	1.0	0.1	11.4
1965	18.3	2.0	*	20.4
1966	33.3	4.9	0.7	38.9
1967	55.6	9.2	0.8	65.6
1968	71.5	19.0	1.2	91.7

1/ Does not include floor give-ups.

* less than fifty thousand dollars

SOURCE: NYSE Member Firm Income and Expense Reports: various years.

TABLE XIII-20

Investment Company Commissions Received and Given-Up
New York Stock Exchange Member Firms
1968

Market	Investment Company Commissions			
	Received ($ millions)	Given-Up 1/ ($ millions)	Retained ($ millions)	Given-Up as a % of received
New York Stock Exchange	192.6	71.5	121.1	37.1
Other Exchanges	43.4	19.0	24.4	43.8
Over-the-Counter	6.9	1.2	5.7	17.4
TOTAL	242.9	91.7	151.2	37.8

1/ Does not include floor give-ups.

SOURCE: NYSE Member Firm Income and Expense Reports: 1968.

TABLE XIII-21

Institutional Investors
Other Than Investment Company Advisers
Directing Commissions 1/
1968

Class of Institutional Investor	Number of Institutions Directing Commissions	Total Amount Directed (thousands of dollars)
Banks	20	6,406
Investment Advisers (non-investment company accounts)	12	1,420
Life Insurance	12	1,494
Property & Liability Ins.	10	506
Self-Administered Pension Funds	4	184
Foundations	2	64
Educational Endowments	9	144
Investment Co. Complexes	46	95,555
TOTAL	78	119,396

1/ Does not include floor give-ups.

SOURCE: Form I-7.

TABLE XIII-22

Give-Ups Paid at the Direction of Investment Companies
New York Stock Exchange Member Firms
1964-1968

Year	Net Give-ups Paid		Net Give-ups Received	
	Percent of Firms	Amount ($ million)	Percent of Firms	Amount ($ million)
1964	18.4	8.2	59.0	4.3
1965	16.6	14.5	60.4	9.6
1966	17.3	28.9	65.4	15.5
1967	19.3	49.3	65.8	22.9
1968	21.2	63.6	60.6	32.8

SOURCE: NYSE Member Firm Income and Expense Reports: various years.

TABLE XIII-23

PERCENTAGE DISTRIBUTION OF NYSE MEMBER FIRMS BY THE AMOUNT GIVEN-UP OR RECEIVED AT THE DIRECTION OF INSTITUTIONAL INVESTORS
1968

Amount ($thousands)	PERCENT OF NYSE MEMBER FIRMS			
	Investment Companies		Others	
	Give-Ups Paid	Give-Ups Received	Give-Ups Paid	Give-Ups Received
0	56.2%	22.3%	75.9%	45.3%
Under 50	16.8%	26.7%	8.3%	29.3%
50-100	6.5%	10.4%	3.6%	7.5%
100-300	7.5%	24.6%	5.4%	9.1%
300-500	1.6%	9.1%	2.1%	6.2%
500-1,000	4.7%	6.0%	2.6%	1.8%
1,000-2,000	4.1%	0.8%	0.8%	0.8%
2,000 and over	2.6%	0.3%	1.3%	
TOTAL	100.0%	100.0%	100.0%	100.0%
Amount ($ millions)	91.7	60.9	35.7	28.2

SOURCE: NYSE Member Firm Income and Expense Reports: 1968.

TABLE XIII-24

Percent of Investment Company Commissions
Received as Give-Ups
New York Stock Exchange Members
1968

Total Commissions Received From Investment Companies ($000)	Percent of Investment Company Commissions Received As Give-Ups							
	0	Under 20	20 to 40	40 to 60	60 to 80	80 to 100	100	TOTAL
under 25	7	1	1		4	2	34	49
25- 50	3		2	1	1	6	17	30
50- 100	2	4	2	3	6	3	16	36
100- 200	8	4	4	1	6	6	16	45
200- 300	2	3	5	3	3	7	8	31
300- 500	3	3	8	10	2	4	2	32
500-1,000	1	8	13	11	5	1	1	40
1,000-2,000	2	7	4	5	4		1	23
2,000 + over	2	33	9	—	—	—	—	44
TOTAL	30	63	48	34	31	29	95	330

SOURCE: NYSE Member Firm Income and Expense Reports: 1968.

TABLE XIII-25

Percent of Investment Company Commissions
Received Which Was Given-Up
New York Stock Exchange Member Firms
1968

Total Commissions Received From Investment Companies ($000)	Percent of Investment Company Commissions Paid As Give-Ups								
	0	Under 10	10 to 20	20 to 30	30 to 40	40 to 50	50 to 60	60 and over	TOTAL
under 25	29	2		3	1	2	4	1	42
25- 50	8		4	2			2		16
50- 100	11			4	1	1	1	1	19
100- 200	14	6	3	5		2	1	1	32
200- 300	4	7	2	1	3	2	2		21
300- 500		6	6	4		2	3	6	27
500-1,000		4	7	4	4	2		1	22
1,000-2,000	1	2	1	5	2	1	6	1	19
2,000 + over	1	3	3	5	8	8	4	5	37
TOTAL	68	30	26	33	19	20	22	16	235

SOURCE: NYSE Member Firm Income and Expense Reports: 1968.

5. 1968 Commission Rate Changes

The prevalence of the give-up demonstrated that NYSE firms specializing in execution and clearance for institutions were willing to perform this function for significantly less than the commission imposed by the NYSE commission schedule and that other NYSE members not participating in the execution and clearance of portfolio orders were receiving commission dollars at the direction of the institution for services unrelated to the portfolio transactions, perhaps for example, for the sale of investment company shares.

As far back as 1963, the Special Study of the Securities Markets expressed concern that the give-up was symptomatic of an inflexible NYSE non-member commission rate schedule that did not consider:

> (a) whether the nonmember is or is not a professional in the securities business,
> (b) the effect of volume of a particular customer's business (whether measured by size of single orders or volume of orders over periods of time) on the cost of serving that customer, and
> (c) a particular customer's use or nonuse of ancillary services covered by the commission rate.[25]

Between the publication of the Special Study and the beginning of 1968, the problems raised by the NYSE commission rate structure were the subject of numerous Commission and NYSE studies.

In a release in early 1968, [26] the Commission asked for comments on two matters before it: (1) proposed Rule 10b-10 under the Securities Exchange Act which would have prohibited investment company managers from directing a broker-dealer to give-up any part of the commission on a securities transaction for an investment company unless the benefits of the division of such commission accrued to the investment company itself and (2) an Exchange proposal which called for a volume discount (the amount and nature of which was to be determined in the future), continuation of customer directed give-ups but with a percentage limitation, prohibition of reciprocal practices that involve rebates of NYSE commissions, a discount for nonmember broker-dealers and prohibitions of institutional access to all stock exchanges.

Comments on the two proposals were received from institutions, the exchanges, broker-dealers, and other interested parties. The Department of Justice, in a lengthy comment, questioned whether fixed minimum rates were "necessary to make the Securities Exchange Act work." [27] To the extent that fixed commissions were not necessary for the purpose, in the Department's view, any fixed rate would be unlawful under the antitrust laws.

On May 28, 1968, the Commission announced its intention to institute public hearings concerning the commission rate structures of registered national securities exchanges and related questions.[28] At these hearings, which commenced July 1, testimony was taken from representatives of the exchanges, investment company managers, broker-dealers, the Department of Justice and others.

Concurrently with the announcement of the public hearings, the

---

[25] SEC, Report of the Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 2 at 349 (1963) ("Special Study").
[26] Securities Exchange Act Release No. 8239 (January 26, 1968).
[27] The quoted language had appeared in Silver v. New York Stock Exchange, 373 U.S. 341, 359 (1963).
[28] Securities Exchange Act Release No. 8324.

Commission requested that the NYSE revise its commission rate schedule to include a volume discount of a specified amount or, in the alternative, to provide for competitive rates on orders in excess of $50,000 in value. This revision was to be an interim step until the Commission could complete its examination of the matters under consideration at the hearings.

In response, the NYSE adopted an interim commission rate structure which included a volume discount and changed its Constitution, to prohibit customer directed give-ups. To effectuate the ban on give-ups, the NYSE added the following sentence to its Constitution:

> No member, member firm or member corporation shall, in consideration of the receipt of listed business and at the direct or indirect request of a non-member or by direct or indirect arrangement with a non-member, make any payment or give up any work or give up all or any part of any commission or other property to which such member, member firm or member corporation is or will be entitled.[29]

The American Stock Exchange and all regional stock exchanges at or about the same time adopted a volume discount and give-up prohibition.

Table XIII–26 shows the revised commission rate schedule which went into effect December 5, 1968. For transactions up to and including 1,000 shares, the schedule remained unchanged. On that portion of an order in excess of 1,000 shares the new rate reduced commissions on all stocks selling below $90 per share. Table XIII–27 shows the effect of the volume discount for stocks selling at different price levels. For a $20 stock the discount per round lot on the portion above 1,000 shares is about 48 percent. The percentage discount declines from that point until at $90 per share, the rate per round lot above 1,000 shares is the same as on the first 1,000 shares. Table XIII–28 shows the application of the interim commission rate schedule to a $40 stock. On 10,000 shares the reduced total commission is about 37 percent lower than under the previous schedule. On an order of 100,000 shares the minimum commission is 40.6 percent lower. In no case was the fixed minimum commission on a single order to exceed $100,000 no matter how high the value of the order. For a $40 stock the $100,000 ceiling on the minimum commission applies on orders of more than 434,000 shares or $17.4 million in value.

The volume discount applicable on orders of over 1,000 shares required some definition of the eligible orders. To qualify for the discount a customer had to express an interest in purchasing over 1,000 shares, although he did not have to disclose the total amount of his order. Thus, a customer could place an order to purchase 1,100 shares of a stock with a broker and by informing the broker that there was "more to come" the customer would qualify not only the one round lot over 1,000 in his order, but also all additional purchases of that same stock on that day. On the other hand, if a customer placed an order for 500 shares, followed later that day by ten other orders to purchase 500 shares of the same stock, none of the shares would qualify for the discount.[30]

A single order for more than 1,000 shares entered by the trust de-

---

[29] NYSE Constitution art. XV, sec. 1.
[30] NYSE, Department of Member Firms, Educational Circulars No. 243, 249 and 317.

partment of a bank or an investment adviser might qualify, provided that it was executed, confirmed and settled for a single brokerage account, even though the order may have been on behalf of several of the bank's customers. Orders for trust and advisory accounts of different beneficiaries, confirmed by the broker-dealer separately to each account, qualify for the discount only if the order for any account exceeds 1,000 shares.

Since the previous rate schedule did not differentiate between any two round lots in determining commissions, some institutions had not found it beneficial to combine orders of two or more customers. Although orders might have been placed at the same time for two customers, these institutions would usually request separate confirmations for each account. In 1969 the policy of most investment advisers remained the same, that is, they continued to request separate confirmations even though in certain instances it meant that the customer would not benefit by the volume discount. In part, this is necessary since accounts may be in the custody of different banks and broker-dealers. In addition, NYSE rule 372 prohibits NYSE members from executing "bunched" orders, that is, a combination of orders accepted from several principals and executed as one lot. Thus, if a member firm executes an order, for example, on behalf of an investment adviser that requests two or more confirmations, each covering a portion of the order, the member firm must charge a full minimum commission on each portion.[31] Those investment advisers that combine orders on behalf of two or more accounts (to be confirmed to the adviser) are affecting transactions for customers and may have to register as broker-dealers.[32]

Other banks sought to combine their orders and some banks that would previously have requested a separate confirmation changed their policy. One bank, however, although it had combined orders prior to the volume discount, now decided it would not combine orders for accounts that would not ordinarily be entitled to the volume discount. (A bank is not required by the Securities Exchange Act to be registered as a broker to effect transactions in securities for its customers.)

Where the volume discount is applicable to a group of customers, some problems arise as to the allocation of the discount as well as the allocation of share cost if more than one execution is involved. In most instances, if more than one customer is involved in an order the cost is distributed on the basis of the average price for the entire order with the volume discount prorated among the customers.

---

[31] NYSE Department of Member Firms, Educational Circular No. 273.

[32] Interviews with some investment advisers having broker-dealer affiliates indicate that they use those affiliates to effect a "bunching" of customers' orders. This in turn necessitates adequate capital to carry the customer's account.

TABLE XIII-26

NYSE Commission Rate Schedule
Effective December 5, 1968

Stocks Selling at $1.00 Per Share or Above

Minimum Commission on First 1,000 Shares of an Order

Money Involved	Per Cent of Money Involved	Plus Stated Amount: For 100 Shares 1/	Plus Stated Amount: For Less Than 100 Share 2/
$100 to $400	2%	$3 3/	$1 3/
$400 to $2,400	1%	7	5
$2,400 to $5,000	1/2%	19	17
Over $5,000	1/10%	39	37

Minimum Commission on Shares in Excess of 1,000 per Order

Money Involved	Per Cent of Money Involved	Plus Stated Amount
$100 to $2,800	1/2%	$4
$2,800 to $3,000	Compute as $2,800	--
$3,000 to $9,000	1/2%	$3
Over $9,000	1/10%	$39

1/ Also, 10 to 99 shares of a 10-share unit stock.

2/ Except for 10 to 99 shares of a 10-share unit stock.

3/ Minimum $6.

NOTE: For transactions in excess of 100 share lot or fraction thereof is considered separately. When the commission on any order computed in accordance with the foregoing schedules is in excess of $100,000, the minimum charge is $100,000.

TABLE XIII-27

NYSE Commission Rates
Before and After Dec. 5, 1968

Price Per Share (dollars)	Commission Per Round Lot Shares in Excess of 1,000 Shares		
	Pre-Dec. 5, 1968 (dollars)	After Dec. 5, 1968 (dollars)	Percent Decrease
10	17	9	35.3
20	27	14	48.1
30	34	18	47.1
40	39	23	41.0
50	44	28	36.4
60	45	33	26.7
70	46	38	17.4
80	47	43	8.5
90	48	48	--
100	49	49	--

TABLE XIII-28

NYSE Commission Rates
Before and After December 5, 1968

Number of Shares	NYSE Minimum Commissions on a Forty Dollar Stock		
	Pre-December 5, 1968 (dollars)	After December 5, 1968 (dollars)	Percent Decrease
100	39	39	--
1,000	390	390	--
10,000	3,900	2,460	36.9
100,000	39,000	23,160	40.6
500,000	195,000	100,000	48.7
1,000,000	390,000	100,000	74.4

6. Impact of 1968 Commission Rate Changes

One of the major effects of the volume discount and abolition of customer directed give-ups was an increase in the number of broker-dealers receiving institutional commissions for the execution of orders. Since institutions could no longer give an order to one broker-dealer and request that it distribute the commissions among others, some institutions began to deal with some broker-dealers for the first time. Table XIII–29 shows, by their 1968 net give-up balance, the amount of actual commissions received from investment companies by NYSE member firms in 1969. Actual commissions are those paid to the broker-dealer confirming the transaction as opposed to give-ups which were paid to persons other than those participating in the order. To the extent that in 1968 investment companies directed some executing brokers to allow other brokers to confirm, the change between the two years in actual commissions received by certain broker-dealers may be understated.

Of 360 firms reporting for both 1968 and 1969, 80 were net payers of give-ups in 1968, while 214 were net recipients. Of the 80 net payers, 46 received a smaller percentage of total actual investment company commissions in 1969 than in 1968, and three additional firms received no investment company commissions. Of the 214 net give-up recipients in 1968, 135 increased their percentage of actual investment company commissions in 1969, while only 36 decreased their percentage. Of the 135 that received a greater proportion of 1969 investment company commissions, 44 had not received any actual commissions in 1968. The actual commissions received by these 135 firms increased from $27.7 million in 1968 to $49.7 million in 1969. Of the $49.7 million, $5.5 million went to the 44 firms that had received no actual commissions in 1968.

The 80 firms that paid give-ups on balance in 1968 received $127 million from investment companies in actual commissions in 1969, about 31percent less than the $184 million they received in 1968. The 214 net give-up recipients on the other hand, increased their actual commissions about 35 percent, from $43 million to $58 million.

Of the total actual commissions paid by these institutional investors in 1968 to NYSE member firms doing business with the public, 80.8 percent were received by net give-up payers. In 1969, however, those who had been net give-up payers in 1968 received only 67.3 percent. Although the decrease may be in part attributable to the volume discount which affected net give-up payers to a greater extent than net give-up recipients, this explanation cannot account for the magnitude of the percentage change. Although net give-up payers received less actual commissions in 1969, they no longer were permitted to give-up at the direction of their investment company customers and were thus keeping much more of the actual commissions received. Table XIII–30 sets forth the combined impact of the volume discount and the give-up abolition on NYSE member firms. It shows that while 1968 net give-up payers received $57.1 million less in actual commissions in 1969, they did not have to give up anything as compared with $58.2 million given up in 1968. From the two changes these net give-up payers came out ahead $1.1 million. Net give-up recipients, on the other hand, although receiving $15.1 million more in

1969 actual commissions than in 1968, no longer received net give-up which in 1968 totaled $30.7 million. For these firms the new rules result in a combined loss of $15.7 million in income.

Many firms, therefore, which had not been used for execution and clearance since an alternative method of compensation was available (the give-up) were sent portfolio orders by investment company advisers after that alternative was eliminated. It is unknown whether these firms improved their execution capabilities between 1968 and 1969 or whether investment companies, as well as other institutional investors using these firms for execution for the first time, became willing to alter their standards of trading in order to pay commissions to firms that had received only give-ups in previous years. Undoubtedly, many broker-dealers had adequate execution capabilities prior to December 5, 1968, but some institutional investors probably preferred the convenience of a small number of lead brokers who could distribute commissions by using give-ups. Other broker-dealers that had attracted business prior to December 5, by offering services other than execution capabilities, appear to have strengthened that capability after the abolition of give-ups. Some of these firms, in fact, opened offices in New York City, hired block traders and increased their advertisement of execution services.

Other firms improved their ability to receive commissions after December 5, by joining a regional exchange.[33] In 1969 the Philadelphia-Baltimore-Washington Stock Exchange (PBW) admitted 69 new member organizations, up from 23 new admissions in 1968.[34] An average of less than 13 new members per year were admitted in the previous four years, ending in 1967. The BSE admitted 41 new member organizations in 1969. In 1968, 31 new member organizations were admitted, most of these in the latter part of the year. Between 1964 and 1967 Boston averaged nine new memberships per year.[35] During 1968 one BSE member solicited broker-dealers to join that exchange in a letter which read in part:

> After December 5 we can help you in replacing give up checks that you will no longer be able to receive by substituting in their place a direct order given you by a Fund. We in turn would execute this order either on the Boston to Stock Exchange or the primary market in accordance with the Fund's instructions to you. We would do this as your floor broker and clearing correspondent on the Boston Stock Exchange and remit to you on this reciprocal arrangement an amount equal to 50 percent of the commission involved. As we would clear for you, this would have no effect on your aggregate indetedness. You would have no complicated problems of bookkeeping. There would be no tying up of your capital. A confirmation and minor entries are all that would be involved. In order for us to engage in this reciprocal arrangement, it would be necessary for you to be a member of the Boston Stock Exchange. This would necessitate the purchase of a seat by you at a current market price of $14,000 and dues are approximately $800 a year. All clearing expenses would be borne by us as your clearing correspondent. The liquidating value of a Boston Stock Exchange seat in cash and securities is currently in excess of this price. The capital requirements of the Boston Stock Exchange in addition to your seat cost are $10,000 for a partnership and $25,000 for a corporation.

---

[33] For a description of how commissions on block trades could be shared after the abolition of give-ups, see ch. XI.C.

[34] In late 1968 the PBW and BSE doubled their total memberships by effecting a two for one split of outstanding shares.

[35] In 1969 there were 23 and 16 new member organizations admitted to the Pacific Coast and Midwest Stock Exchange, respectively.

TABLE XIII-29

Actual Commissions Received From Investment Companies 1968-1969
By 1968 Give-Up Balance
New York Stock Exchange Member Firms

1968 Give-Up Balance of Firm		Actual Commissions Received From Investment Companies: 1969 Share Higher Than 1968		No 1969 Commissions	1968 Share Higher Than 1969		All Firms
		Some Commissions Received In 1968	No Commissions Received In 1968	No 1968 Commissions	No Commissions Received In 1969	Some Commissions Received In 1969	
Net Payer	Number of Firms	30		1	3	46	80
	1969 Actual Commissions ($ millions)	66.4				60.5	126.9
	1968 Actual Commissions ($ millions)	57.3			1.7	125.0	184.0
Even	Number of Firms	3	7	46	7	3	66
	1969 Actual Commissions ($ millions)	1.5	2.2			0.2	4.0
	1968 Actual Commissions ($ millions)	0,3			0.3	0.4	1.1
Net Recipient	Number of Firms	91	44	43	11	25	214
	1969 Actual Commissions ($ millions)	44.2	5.5			7.9	57.6
	1968 Actual Commissions ($ millions)	27.7			0.7	14.2	42.6
All Firms	Number of Firms	123	51	90	21	74	360
	1969 Actual Commissions ($ millions)	112.2	7.7			68.7	188.5
	1968 Actual Commissions ($ millions)	85.3			2.8	139.6	227.7

Source: NYSE Member Firm Income & Expense Reports: 1968, 1969.

TABLE XIII-30

Impact of the Volume Discount and the
Abolition of Investment Company Directed Give-Ups
New York Stock Exchange Member Firms 1969

1968 Investment Company Directed Give-Up Balance of Firms	1968 Investment Company Directed Give-Up Balance ($ millions)	Increase (decrease) in Actual Commissions Received 1968 to 1969 ($ millions)	Net Increase or (decrease) in Gross Income 1968-1969 ($ millions)
Payer	58.2	(57.1)	1.1
Even		3.0	3.0
Recipient	(30.7)	15.0	(15.7)
All Firms	27.5	(39.1)	(11.6)

Source: NYSE Member Firm Income & Expense Reports: 1968, 1969.

7. Overall and Institutional Investor Trends 1969–1970

In 1969 and the first half of 1970 the volume of business done by broker-dealers generally declined. After six straight years of increasing volume, 1969 saw the start of a decline which has persisted into late 1970. Share volume on all exchanges declined 6.6 percent, from 5.31 billion shares in 1968 to 4.96 billion in 1969. Declining prices during this period amplified the impact. The value of shares traded on all exchanges declined 10.7 percent, from $196 billion in 1968 to $175 billion in 1969. The year 1969 was also the first full year of the interim commission rate structure with its volume discount.

As shown on Table XIII–31 commissions on NYSE transactions declined 23.1 percent even though dollar volume declined only 10.6 percent. The decline in commissions for transactions on other exchanges and in the over-the-counter market was less severe, 20.0 percent and 13.4 percent, respectively.

The decline in total commission volume was accompanied by a decline in other phases of the broker-dealer business. Table XIII–32 shows the difference between 1968 and 1969 gross income for selected sources of broker-dealer income. The largest absolute decline occurred in profits from trading and arbitrage, down $200 million or 31 percent from 1968. Decreases in dividends, interest and mutual fund sales also were reported. Although gross interest on customers' margin accounts increased, the actual volume of average margin debt declined 16.0 percent, from $6.3 billion in 1968 to $5.3 billion in 1969, and thus the increase in gross interest is entirely attributable to higher interest rates.

The overall decline in volume appears to reflect a substantial decrease in individual investor volume between 1968 and 1969. Table XIII–33 shows that between 1968 and 1969 dollar volume of most institutional equity transactions increased on the average 18.7 percent, from 8.6 percent for mutual funds to 71.2 percent for property and liability insurance companies.

TABLE XIII-31

Dollar Volume on Exchanges
and NYSE Member Firms' Commissions

1968-1969

	1968 ($millions)	1969 ($millions)	Percent Decrease
NYSE Dollar Volume	144,978	129,603	10.6
Other Exchanges Dollar Volume	51,380	45,695	11.1
NYSE Members' NYSE Commissions	2,017	1,551	23.1
NYSE Members' Other Exchange Commissions	793	634	20.0
NYSE Members' OTC Commissions	436	377	13.4
NYSE Members' Total Commissions	3,245	2,563	21.0

Source: NYSE Member Firm Incomes Expense Reports: 1968, 1969.

TABLE XIII-32

Income From Sources Other than Commissions
NYSE Member Firms

1968-1969

Income Source	1968 ($millions)	1969 ($millions)	Percent Change
Profit from trading and arbitrage	641	442	-31.0
Profit or loss from Underwriting Syndicates & Selling Groups	462	495	7.1
Dividends and interest received by reporting firm on investments	55	35	-36.4
Income from sales of mutual fund shares to customers at retail or to broker-dealers at wholesale	157	139	-11.5
Fees for account supervision investment advice	29	44	51.7
Interest (gross) received on customers' accounts	445	472	6.1

Source: NYSE Member Firm Income & Expense Reports: 1968, 1969.

TABLE XIII-33

Selected Institutions

Total Purchases and Sales of Common Stock

Class of Institutional Investor	1968	1969	Percent Increase
Private noninsured pension funds	20,100	25,500	26.9
Open-end investment companies	38,595	41,910	8.6
Life insurance companies	4,655	5,740	23.3
Property and liability insurance cos.	3,890	6,660	71.2
Total of above institutions	67,245	79,815	18.7

Source: S.E.C. Statistical Release No. 2434, April 13, 1970.

8. Profitability of Institutional Investor Business in 1969–1970

a. *Total business*

The downturn in total volume had broad impact on broker-dealers. Thirty-seven percent of NYSE member firms lost money in 1969; only 2.6 percent had lost money in 1968. Table XIII-34 shows the pre-tax profits and losses of NYSE member firms grouped by the average size of their commission transactions. While 42 percent of the retail firms (average commission income per transaction under $50) suffered losses in 1969, only 18 percent of the institutional firms (average commission income per transaction over $100) suffered losses. The most profitable firms in 1969 as in 1968 were the institutional firms. Twelve percent of the institutional firms, but only 2 percent of the retail firms, had pre-tax profits of $5 million or more. The median pre-tax profit on total business was $128,000 for all firms, $63,000 for retail firms, but $722,000 for institutional firms. Tables XIII-35 and XIII-36 show for 1969 the median income of NYSE member firms grouped by size of commission income per transaction, and the difference between 1968 and 1969. The median profits on total business decreased $600,000 for retail firms and $1.7 million for institutional firms. Although in absolute dollars the decline was greatest for institutional firms, the proportional decline for retail firms was 90.6 percent, as compared to 70.2 percent for institutional firms.

A decrease in the pre-tax return on capital of these firms accompanied the decrease in profits. The 1969 median return on capital for retail firms was 3.2 percent and for institutional firms 12.2 percent. Table XIII-37 shows the return on capital of NYSE member firms for 1969. Although only 3 percent of the firms doing primarily a retail business had returns of 30 percent or higher, almost a fourth of the institutional firms had returns that high. Twenty percent of the retail firms had negative returns of 10 percent or more; only eight percent of the institutional firms had negative returns of 10 percent or more.

The decrease in profitability of firms may reflect increases in certain costs as well as decreases in volume. Table XIII-38 shows expenses in 1968 and 1969 for all firms and for firms classified by institutional or retail business. The largest cost increases occurred in interest, clerical and administrative salaries, and office and equipment costs. Since give-ups were considered by the NYSE to be a commission expense, their elimination caused a reduction in that category. Registered representatives' compensation, which for retail firms is normally paid as a percentage of the gross commissions earned by the registered representative, declined approximately the same percentage as gross income. It represented, therefore, the same percentage of gross income in both periods, about 21 percent. Since institutional salesmen are often on salaries or other arrangements not tied to gross commissions, the amount paid to salesmen of the institutional firms did not decline proportionately. In 1968 their compensation represented 7.2 percent of gross income and in 1969 it was 8.9 percent of gross income.

b. *Security commission business*

In 1969 the security commission business of most NYSE member firms was unprofitable. NYSE firms as a group showed a combined loss before taxes of $75.5 million. Table XIII–39 shows that in 1969, despite the volume discount, the institutional firms were still much more profitable than the retail firms. Almost 70 percent of the retail firms lost money on their commission business; only 20 percent of the institutional firms lost money. While only 4 percent of the retail firms had profits of $1 million or more, 36 percent of the institutional firms enjoyed that level of profitability. The median pre-tax loss was $37,000 for all firms and was $82,000 for retail firms. Institutional firms, however, had a median profit of $530,000 (Table XIII–35).

The difference between 1968 median commission profits and 1969 median commission losses was $346,000 for all firms, and was $246,000 for retail firms. The difference in the median profits in the two years for the institutional firms was $508,000. The profit margins on commission income were still much higher for the institutional firms than for the retail firms. Table XIII–40 shows that more than one-third of the institutional firms had a 1969 profit margin on commission business in excess of 30 percent. Less than 6 percent of the retail firms had that high a profit margin. An additional one-third of the institutional firms, but only 6 percent of the retail firms, had profit margins between 10 and 30 percent. Moreover, 22 percent of the retail firms had negative margins of 20 percent or more, while none of the institutional firms fared that poorly.

Table XIII–41 shows the percentage difference between income and cost per order for 1969, as determined by a study conducted for the NYSE by NERA. In their analysis, the cost of handling an order for 100 shares exceeded the commission by between 40 and 105 percent for stocks selling from $10 to $100 per share. Indeed, the NERA study reported that on some priced stocks the exchange member needed an order of 400 shares or more to earn a profit. On the other hand, 100,000 shares of a $40 stock reportedly produced a commission which exceeded costs by 11 percent and the commission on 100,000 shares of a $100 stock exceeded costs by 23 percent.[36]

The NYSE included margin interest income in calculating the profitability of members' commission business in 1969. Since most margin business is done by individuals rather than institutions, and since it has normally been a profitable aspect of the business, inclusion of margin interest in commission business profitability would tend to bring the profits of the retail firms closer to those of institutional firms. Table XIII–42 indicates that when margin income is included in the commission business, the size of the group of retail firms losing money declined from 70 percent to 63 percent. Similarly, after the inclusion of margin income the percentage of institutional firms losing

---

[36] NERA has estimated that there has been a substantial increase in the cost of handling orders in 1970. This increase is due in part to the combination of higher costs and decreased volume.

money declines from 20 to 16 percent. While no institutional firm had a negative return as low as minus 20 percent on this combined business, about 22 percent of the retail firms had such negative returns. Conversely, while 45 percent of the institutional firms had returns on capital of 20 percent or higher only 12 percent of the retail firms had such returns.

c. *Other business*

Unlike the commission business, the 1969 profitability of the other business of institutional firms was lower than the profitability of the other business of the retail firms. The median pre-tax profits on other business were $57,000 and $191,000 for institutional and retail firms, respectively (Table XIII–35). This represented a 91 percent decline in other business profitability from 1968 for the institutional firms and a 54 percent decline for the retail firms. While 42 percent of institutional firms, as shown on Table XIII–43, lost money on their other business, only 21 percent of the retail firms suffered losses. Over 5 percent of the retail firms and 4 percent of the institutional firms earned at least $5 million before taxes on their other business.

TABLE XIII-34

Pre-Tax Profit-Total Business
By Commission Income Per Transaction
NYSE Member Firms
1969

(a)

Commission Income Per Transaction (dollars)	PRE-TAX PROFIT-TOTAL BUSINESS ($000)							
	Loss	Under 250	250 to 500	500 to 1000	1000 to 5000	5000 to 10000	10000 and Over	TOTAL
Under 50	41.9	22.7	12.7	10.9	10.0	1.3	0.4	100.0
50 - 100	34.0	22.0	11.0	12.0	14.0	6.0	1.0	100.0
100 and over	18.0	20.0	6.0	12.0	32.0	6.0	6.0	100.0
TOTAL	36.7	22.2	18.8	18.8	18.8	5.2	2.2	100.0

(b)

Commission Income Per Transaction (dollars)	PRE-TAX PROFIT-TOTAL BUSINESS ($000)							
	Loss	Under 250	250 to 500	500 to 1000	1000 to 5000	5000 to 10000	10000 and Over	TOTAL
Under 50	69.1	61.9	67.4	58.1	53.5	25.0	20.0	60.4
50 - 100	14.8	26.2	25.6	27.9	32.6	50.0	20.0	26.4
100 and over	6.5	11.9	7.0	14.0	37.2	25.0	60.0	13.2
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: NYSE Member Firm Income & Expense Reports: 1969

TABLE XIII-35

Median Pre-Tax Profit
By Commission Income Per Transaction
New York Stock Exchange Member Firms
1969

Commission Income Per Transaction (dollars)	Median Pre-Tax Profit (Loss) ($ thousands)		
	Commission Business	Other Business	Total Business
under 50	(82)	191	63
50 to 100	46	128	163
100 and over	530	57	722
all firms	(37)	161	128

Source: NYSE Member Firm Income & Expense Reports: 1969

TABLE XIII-36

Difference in Median Pre-Tax Profits
By Commission Income Per Transaction
New York Stock Exchange Member Firms
1968-1969

Commission Income Per Transaction (dollars)		Median Pre-Tax Profits		
		Commission Income	Other Business	Total Business
under 50	change ($ 000)	-264	-227	-609
	percent difference	-145.1	- 54.3	- 90.6
50 to 100	change ($ 000)	-478	-415	-1031
	percent difference	- 91.2	- 76.4	- 86.3
100 and over	change ($ 000)	-508	-599	-1699
	percent difference	- 48.9	- 91.3	- 70.2
all firms	change ($ 000)	-346	-317	- 696
	percent difference	-112.0	- 66.3	- 84.5

Source: NYSE Member Firm Income & Expense Reports: 1968, 1969.

TABLE XIII-37

Pre-Tax Return on Capital-Total Business
By Commission Income Per Transaction
NYSE Member Firms

1969

(a)

Commission Income Per Transaction (dollars)	Return on Capital-Total Business: Loss		Profit						
	10 and over	Under 10	Under 10	10 to 20	20 to 30	30 to 40	40 to 50	50 and over	Total
Under 50	19.7	22.3	32.8	16.2	6.1	0.9	1.3	0.9	100.0
50 - 100	10.0	24.0	27.0	25.0	6.0	4.0	3.0	1.0	100.0
100 and over	8.0	10.0	30.0	22.0	6.0	8.0	8.0	8.0	100.0
Total	15.6	21.1	30.9	19.3	6.1	2.6	2.6	1.8	100.0

(b)

Commission Income Per Transaction (dollars)	Return on Capital-Total Business: Loss		Profit						
	10 and over	Under 10	Under 10	10 to 20	20 to 30	30 to 40	40 to 50	50 and over	Total
Under 50	76.3	63.8	64.1	50.7	60.9	20.0	30.0	28.6	60.4
50 - 100	16.9	30.0	23.1	34.2	26.1	40.0	30.0	14.3	26.4
100 and over	6.8	6.3	12.8	15.1	13.0	40.0	40.0	57.1	13.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: NYSE Member Firm Income & Expense Reports: 1969

Table XIII-38
Expenses of NYSE Member Firms
1968-1969

		Retail Firms		Institutional Firms		All Firms	
		1968	1969	1968	1969	1968	1969
Commissions and Other Variable Fees	($000)	315,557	222,979	118,122	64,696	561,628	366,213
	(percent)	9.2	7.5	12.6	9.0	10.4	8.1
Registered Representatives	($000)	725,038	627,771	67,828	64,100	945,253	798,889
	(percent)	21.2	21.0	7.2	8.9	17.5	17.7
Clerical and Administrative Employees	($000)	753,261	805,089	136,991	151,133	1,095,325	1,161,135
	(percent)	22.0	27.0	14.6	21.1	20.3	25.8
Communication Costs	($000)	250,117	292,516	27,501	32,035	330,794	378,794
	(percent)	7.3	9.8	2.9	4.5	6.1	8.4
Occupancy and Equipment Costs	($000)	168,020	212,680	26,000	30,461	236,761	291.622
	(percent)	4.9	7.1	2.8	4.3	4.4	6.5
Promotional Costs	($000)	95,864	107,915	17,603	21,326	141,099	156,242
	(percent)	2.8	3.6	1.9	3.0	2.6	3.5
Interest Expense	($000)	190,783	245,291	135,163	130,978	392,374	442,909
	(percent)	5.6	8.2	14.4	18.3	9.7	9.8
Other Expenses	($000)	216,890	215,446	63,150	61,513	343,187	335,821
	(percent)	6.3	7.2	6.7	8.6	6.4	7.5
Total Expense	($000)	2,715,530	2,729,688	592,357	556,241	4,046,421	3,931,786
	(percent)	79.3	91.5	63.2	77.6	74.9	87.3
Gross Income	($000)	3,423,810	2,984,852	936,837	716,677	5,402,794	4,505,785
	(percent)	100.0	100.0	100.0	100.0	100.0	100.0

Note: The firms have been categorized as institutional or retail separately for each year.
Source: NYSE Member Firm Income & Expense Reports: 1968, 1969.

TABLE XIII-39

Pre Tax Profit Commission Business
By Commission Income Per Transaction
NYSE Member Firms
1969

(a)

PRE-TAX PROFIT COMMISSION BUSINESS ($000)

Commission Income Per Transaction (dollars)	LOSS				PROFIT				TOTAL
	5000 and over	1000 to 5000	500 to 1000	0 to 500	0 to 500	500 to 1000	1000 to 5000	5000 and over	
Under 50	5.2	10.0	9.6	45.0	22.7	2.1	3.9		100.0
50 - 100		3.0	7.0	30.0	36.0	10.0	14.0		100.0
100 and over		2.0	4.0	14.0	28.0	16.0	28.0	8.0	100.0
TOTAL	3.2	7.1	7.9	36.9	26.9	6.9	9.8	1.1	100.0

(b)

PRE-TAX PROFIT COMMISSION BUSINESS ($000)

Commission Income Per Transaction (dollars)	LOSS				PROFIT				TOTAL
	5000 and over	1000 to 5000	500 to 1000	0 to 500	0 to 500	500 to 1000	1000 to 5000	5000 and over	
Under 50	100.0	85.2	71.0	73.6	51.0	30.8	24.3		60.4
50 - 100		11.1	22.6	21.4	35.3	38.5	37.8		26.4
100 and over		3.7	6.5	5.0	13.7	30.8	37.8	100.0	13.2
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: NYSE Member Firm Income & Expense Reports: 1969.

TABLE XIII-40.

Pre-Tax Profit Margin-Commission Business
By Commission Income Per Transaction
NYSE Member Firms
1969

(a)

PRE-TAX PROFIT MARGIN-COMMISSION BUSINESS ($000)

Commission Income Per Transaction (dollars)	LOSS				PROFIT				TOTAL
	30 & over	20-30	10-20	0-10	0-10	10-20	20-30	30 & over	
Under 50	9.6	12.2	22.3	25.8	18.3	4.8	1.3	5.7	100.0
50 - 100	5.0	3.0	7.0	25.0	33.0	13.0	4.0	10.0	100.0
100 and over			8.0	12.0	14.0	14.0	18.0	34.0	100.0
TOTAL	7.1	8.2	16.4	23.7	21.6	8.2	4.2	10.6	100.0

(b)

PRE-TAX PROFIT MARGIN-COMMISSION BUSINESS ($000)

Commission Income Per Transaction (dollars)	LOSS				PROFIT				TOTAL
	30 & over	20-30	10-20	0-10	0-10	10-20	20-30	30 & over	
Under 50	81.5	90.3	82.3	65.5	51.2	35.5	18.8	32.5	60.4
50 - 100	18.5	9.7	11.3	27.8	40.2	41.9	25.0	25.0	26.4
100 and over			6.5	6.7	8.5	22.6	56.3	42.5	13.2
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: NYSE Member Firm Income & Expense Reports: 1969.

TABLE XIII-41

PERCENT DIFFERENCE BETWEEN 1969 COST PER ORDER AND MINIMUM COMMISSION RATE EFFECTIVE DECEMBER 5, 1968

Round Lots

Shares Per Order	Price of Stock: $10	$20	$40	$50	$75	$100
100	90.4%	47.0%	40.1%	41.3%	74.5%	104.5%
200	59.4	22.4	15.7	16.5	43.3	67.6
300	45.5	11.5	5.3	5.9	30.2	52.2
400	36.9	4.8	−1.1	−0.6	22.1	42.7
500	30.7	0.0	−5.8	−5.3	16.2	35.7
1,000	14.0	−13.4	−19.0	−18.8	−0.8	15.5
5,000	43.0	8.7	−9.1	−14.4	−18.6	−16.0
10,000	44.6	11.5	−7.2	−13.1	−19.9	−18.1
100,000	31.3	4.8	−11.1	−16.7	−24.4	−22.7

Source: Stock Brokerage Commissions: The Development and Application of Standards of Reasonableness for Public Rates, Table XI-3.

Table XIII-42

Pre-Tax Return on Capital-Commission and Margin Interest Business
By Commission Income Per Transaction
NYSE Member-Firms
1969

(a)

Commission Income Per Transaction (dollars)	PRE-TAX RETURN ON CAPITAL-COMMISSION AND MARGIN INTEREST BUSINESS										
	LOSS					PROFIT					
	40 and over	30 to 40	20 to 30	10 to 20	Under 10	Under 10	10 to 20	20 to 30	30 to 40	40 and over	TOTAL
Under 50	8.9	4.5	9.4	16.5	23.7	15.6	9.4	4.5	4.0	3.6	100.0
50-100	3.1	1.0	4.1	6.2	19.6	25.8	19.6	5.2	3.1	12.4	100.0
100 and over				4.1	12.2	12.2	26.5	16.3	6.1	22.4	100.0
All Firms	6.2	3.0	6.8	12.2	21.1	17.8	14.3	6.2	4.1	8.4	100.0

(b)

Commission Income Per Transaction (dollars)	PRE-TAX RETURN ON CAPITAL-COMMISSION AND MARGIN INTEREST BUSINESS										
	LOSS					PROFIT					
	40 and over	30 to 40	20 to 30	10 to 20	Under 10	Under 10	10 to 20	20 to 30	30 to 40	40 and over	TOTAL
Under 50	87.0	90.9	84.0	82.2	67.9	53.0	39.6	43.5	60.0	25.8	60.5
50-100	13.0	9.1	16.0	13.3	24.4	37.9	35.8	21.7	20.0	38.7	26.2
100 and over				4.4	7.7	9.1	24.5	34.8	20.0	35.5	13.2
All Firms	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: NERA, unpublished data.

TABLE XIII-43

Pre-Tax Profit Other Business
By Commission Income Per Transaction
NYSE Member Firms
1969

(a)

Commission Income Per Transaction (dollars)	PRE-TAX PROFIT OTHER BUSINESS ($000)							
	Loss	Under 250	250 to 500	500 to 1000	1000 to 5000	5000 to 10000	10000 and Over	TOTAL
Under 50	21.4	33.2	13.5	14.8	11.8	2.6	2.6	100.0
50 - 100	28.0	33.0	13.0	9.0	14.0	3.0		100.0
100 and over	42.0	18.0	10.0	8.0	18.0	2.0	2.0	100.0
TOTAL	25.9	31.1	12.9	12.4	13.2	2.6	1.8	100.0

(b)

Commission Income Per Transaction (dollars)	PRE-TAX PROFIT OTHER BUSINESS ($000)							
	Loss	Under 250	250 to 500	500 to 1000	1000 to 5000	5000 to 10000	10000 and Over	TOTAL
Under 50	50.0	64.4	63.3	72.3	54.0	60.0	85.7	60.4
50 - 100	28.6	28.0	26.5	19.1	28.0	30.0		26.4
100 and over	21.4	7.6	10.2	8.5	18.0	10.0	14.3	13.2
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: NYSE Member Firm Income and Expense Reports: 1969.

C. ALLOCATION OF COMMISSION AND OVER-THE-COUNTER BUSINESS BY INSTITUTIONAL INVESTORS

1. Commissions Paid by Institutional Investors

Broker-dealers receive their compensation for services rendered to institutional investors in the execution of orders to purchase or sell securities through receipt of commissions if acting as agent or through the opportunity to make a trading profit if acting as principal.

a. *Magnitude of commissions paid by institutional investors*

Most commissions paid by institutional investors are paid to broker-dealers for executing transactions on a stock exchange; a lesser total is paid for the execution of agency orders in the over-the-counter market.

Investment companies and bank trust departments are by far the largest source of institutional investor brokerage commissions. In 1968, 49 of the 50 banks with the largest trust departments paid $222 million in commissions. The investment company complexes managed by the largest investment advisers paid more than $275 million in commissions that year. Although brokerage data were available for the non-investment company accounts of only two of the 10 largest investment advisers, these accounts ranked third, paying $28 million in commissions.

The largest life insurance and property and liability insurance companies as a group paid $23 million and $9 million in commissions, respectively. The self-administered institutions, that is, pension funds, educational endowments and foundations accounted for commissions of only $5 million, $4 million, and $2 million, respectively.

Table XIII–44 shows the amount of commissions paid by individual institutions of each type during 1968. Six of the banks and seven of the investment company complexes paid more than $10 million each in commissions in 1968. These six banks accounted for more than $96 million, or 43 percent, of the commissions paid by the 49 banks. The seven investment company complexes paid almost $117 million in commissions, about 42 percent of the commissions paid by the 57 investment company complexes studied. These 13 institutions represent 38 percent of the total commissions paid by all of the institutions in the Study sample.

b. *Concentration of commissions paid by institutional investors*

The number of broker-dealers with which any one institution does business varies widely. For instance, as shown in Table XIII–45, the number of broker-dealers confirming transactions to each of the largest banks ranged from a low of 55 to a high of 1,022, with a mean of 212. Through use of the give-up, banks were able to compensate, on the average, six additional broker-dealers.[37] The number of broker-dealers confirming transactions to the investment adviser managed investment company complexes ranged from one (for some of the broker-dealer managed mutual funds) to a high of 408, with a mean of 136.

---

[37] Some banks used floor give-ups as described in sec. B.4, above. Since the recipient of a floor give-up confirmed the transaction it is included in the total of confirming broker-dealers. If the executing broker did not confirm any transaction it would not be included in the number of confirming or give-up brokers.

Investment company complexes, however, used the give-up extensively to compensate, on the average, 59 additional broker-dealers. Four investment company complexes directed give-ups to between 200 and 300 nonconfirming broker-dealers, and two to over 400 nonconfirming broker-dealers.

Table XIII-46 shows that 72 percent of the broker-dealers in the random sample doing a general securities business received commissions from one or more of the institutional investors in the sample. The investment companies paid some commissions to 52 percent of the broker-dealers, banks paid some commissions to 48 percent of the broker-dealers, and the other types of institutional investors paid some commissions to a smaller number of broker-dealers, ranging from 29 percent for insurance companies to 14 percent with self-managed institutions.

Table XIII-47 shows the commissions paid by each institutional investor type in the sample to the 50 broker-dealers receiving the greatest amount of net commissions from them. Commissions (net of give-ups paid and received) received by the top 50 broker-dealers (not necessarily the same 50 for each institutional category) ranged from 56 percent of the total commissions paid by banks to 89 percent of total commissions paid by investment advisers. The investment companies, self-managed institutions, and insurance companies paid their top 50 broker-dealers, respectively, 61 percent, 77 percent and 79 percent of their total commissions. The unexpectedly high concentration in investment adviser commission payments may be attributed in part to the disproportionately high number of accounts in the sample managed by broker-dealer affiliated advisers. The 10 broker-dealers receiving the largest amount of business from all institutions received 21 percent of the total. The top 10 firms dealing with the banks received 22 percent of the total, and the top 10 firms dealing with the non-investment company accounts managed by the investment advisers received 53 percent of the total.

Two of the brokers were among the top 10 for each of the institutional types, two more for four of the five institutional types and an additional two for three of them. Twenty-eight different broker-dealers, however, were among the top 10 firms for at least one type of institution.

c. *Characteristics of broker-dealers receiving commissions from institutional investors*

Table XIII-48 shows, by exchange membership, the percentage of broker-dealers in the random sample receiving various amounts of institutional business. Of the broker-dealers doing a general securities business, about 32 percent of the sample were members of the NYSE while 54 percent were not members of the NYSE, American Stock Exchange (Amex) nor any regional exchange where NYSE or Amex stocks are dually traded ("non-members"). Over 98 percent of the NYSE members, but only 51 percent of non-members, received some commissions from the largest institutional investors. Of the sample firms, 14 percent were not members of the NYSE but were members of Amex or one of the regional exchanges where NYSE and Amex stocks are traded, 93 percent of these firms received commissions from some institutional investors.

Of the firms that received more than $1 million in institutional commissions, 92 percent were members of the NYSE, and the remainder were members of the Midwest or Pacific Coast Stock Exchanges. About 17 percent of the NYSE members doing a public business each received more than $1 million in commissions from the largest institutional investors.

Table XIII–49 shows the distribution of broker-dealers receiving institutional commissions classified by their total capital. The more highly capitalized firms tend to receive greater amounts of institutional commissions. Ninety-five percent of the firms with under $100,000 in total capitalization received less than $25,000 in institutional commissions. At the other extreme all broker-dealers with $5 million or more in total capital received some institutional business, 44 percent receiving at least $1 million of such business.

An examination of Table XIII–50 shows the distribution of broker-dealers receiving institutional business classified according to gross income. Fifty-two percent of the broker-dealers with gross income in excess of $5 million from all sources received at least $500,000 in commissions from institutional investors; an additional 40 percent received between $100,000 and $500,000. Of the broker-dealers with gross income under $1 million, 39 percent received no institutional commissions, and an additional 46 percent received less than $25,000 in such commissions.

d. *Institutional investor commissions as a percent of broker-dealer gross income*

Tables XIII–51, XIII–52 and XIII–53 show for broker-dealers of different characteristics the percentage of their gross income from commissions paid by the largest institutional investors. For 69 percent of the broker-dealers, such commissions represented less than 5 percent of their gross income from all sources, and for only 2 percent of the broker-dealers did it represent as much as 25 percent of their total gross income.

Table XIII–51 shows the relative importance of such commissions by exchange membership. Fifty-nine percent of the NYSE members in the sample received at least 5 percent of their gross income from commissions from institutional investors, while only 14 percent of the non-members received 5 percent or more of their total gross income from institutional investor commissions.

Tables XIII–52 and XIII–53 show the distribution of firms by the amount of institutional commissions received in 1968, by their total capital and gross income. The smaller firms generally received a small percentage if any of their gross income from institutional commissions. Seventy-five percent of the firms with total capital of above $1 million and 78 percent of those with gross income of under $1 million received under 5 percent of their gross income from institutional commissions. For the larger firms institutional commissions generally represented a greater portion of their income. Institutional commissions represented less than 5 percent of the gross income of only 28 percent of the firms with capital of $5 million and over and 32 percent of the firms with gross income of $5 million and over.

TABLE XIII-44

INSTITUTIONAL INVESTORS
COMMISSIONS PAID TO BROKER-DEALERS
1968

Commissions Paid (thousands of dollars)	Number of Institutional Investors								
					Self-Administered			Investment Company Complexes	
	Banks	Investment Advisers	Life Insurance	Property & Casualty Insurance	Pension Funds	Foundations	Educational Endowments	Investment Adviser Managed	Insurance Company Managed
0- 250		15	6	6	6	8	10	7	5
250- 500	1	5	5	8	3		3	3	
500- 1,000	5	6	5	6	2	2	2	5	
1,000- 2,000	12	8	7	1	2		1	7	
2,000- 3,000	11	1	2					10	
3,000- 5,000	6		1					9	
5,000-10,000	7	1						9	
10,000-15,000	2							2	
15,000-20,000	3							2	
Over 20,000	1							3	
TOTAL	48	36	26	21	13	10	16	57	5

Source: Form I-7

TABLE XIII-45

INSTITUTIONAL INVESTORS
NUMBER OF BROKER-DEALERS RECEIVING COMMISSIONS
1968

Number of Broker-Dealers Confirming Transactions	Number of Institutional Investors							Investment Company Complexes	
					Self-Administered				
	Banks	Investment Advisers	Insurance	Property & Casualty Insurance	Pension Funds	Foundations	Educational Endowments	Investment Adviser Managed	Insurance Company Managed
1 - 25		17	1	1	5	7	5	5	2
26 - 50		6	2	5	1	1	4	3	1
51 - 100	10	9	15	10	4	1	7	7	2
101 - 150	12	3	2	4	3	1		11	
151 - 200	8		6	1				6	
201 - 300	9	1						10	
301 - 400	3							6	
401 - 500	2							5	
500 - 1,000	3							4	
Over 1,000	1								
TOTAL	48	36	26	21	13	10	16	57	5

Source: Form I-7

TABLE XIII-46

Concentration of Commissions Paid by Institutional Investors
Calendar Year 1968

Type of Institution	Percent of Broker-Dealers Paid Commissions By Institutional Investors 1/
Banks	48
Investment Companies	52
Insurance Companies	29
Investment Advisers	28
Self-Managed Institutions	14
All Institutions	64

1/ Excludes any broker-dealer paid less than $500 of such commissions

Source: Form I-7

Table XIII-47

Commissions Received by Broker-Dealers From Institutional Investors
Calendar Year 1968

Top Fifty Broker-Dealers[1]	All Institutions		47 Banks		Investment Companies		Insurance Companies		Self Managed Institutions		Investment Advisers	
	Commissions Received (000)	Cumulative Percent of Total	Commissions Received (000)	Cumulative Percent of Total	Commissions Received (000)	Cumulative Percent of Total	Commissions Received (000)	Cumulative Percent of Total	Commissions Received (000)	Cumulative Percent of Total	Commissions Received (000)	Cumulative Percent of Total
1 - 10	119,080	20.9	47,940	21.3	66,350	24.1	9,370	29.3	4,224	35.5	14,707	52.6
11 - 20	78,650	34.7	26,450	33.9	38,360	38.0	5,880	47.8	1,889	51.4	4,121	67.3
21 - 30	60,140	45.3	21,530	43.7	28,800	48.5	4,180	60.8	1,371	62.9	2,486	76.2
31 - 40	43,250	52.9	16,470	51.2	18,890	55.3	3,040	70.4	965	71.0	2,089	83.7
41 - 50	32,140	58.6	11,710	55.5	14,240	60.5	2,270	77.5	674	76.7	1,522	89.1
All Others	235,860	100.0	95,514	100.0	108,750	100.0	7,200	100.0	2,776	100.0	3,047	100.0
TOTAL	569,120		219,614		275,390		31,940		11,899		27,972	

1/ The top fifty broker-dealers differ for the different categories of institutions.

Source: Form I-7

53-940 O - 71 - pt. 4 - 54

Table XIII-48

Distribution of Broker-Dealers By Commissions Received From Institutional Investors and Exchange Membership 1/
Calendar Year 1968

Commissions Received From Institutional Investors ($000)	EXCHANGE MEMBERSHIP					
	Member of NYSE	Regular Member of AMEX	Regular Member of MWSE or PCSE	Regular Member of Other Exchange Where NYSE and Amex Stocks are Dually Traded	All Others Including Non-Members of any Exchange	Total
0	0.5		0.5	0.5	26.5	28.0
Under 25	5.0	0.5	3.5	2.0	23.5	34.5
25 - 100	5.0		3.0	1.5	1.5	11.0
100 - 500	13.0	1.0	0.5	0.5	1.5	16.5
500 - 1000	3.0				1.0	4.0
1000 and over	5.5		0.5			6.0
Total	32.0	1.5	8.0	4.5	54.0	100.0

1/ Categories of exchange membership are mutually exclusive from left to right.

Source: Forms I-7, I-61

TABLE XIII-49

Distribution of Broker-Dealers
By Commissions Received from Institutional Investors
and Total Capital
Calendar Year 1968

Commissions Received From Institutional Investors ($000)	Total Capital ($000)						
	Not Available	under 100	100 to 1000	1000 to 5000	5000 to 10000	10000 and over	Total
0	6.5	15.5	5.5	0.5			28.0
under 25	3.5	11.0	16.5	3.0	0.5		34.5
25-100	0.5	0.5	5.0	4.0	1.0		11.0
100-500	0.5	0.5	5.5	7.0	2.5	0.5	16.5
500-1000	0.5	0.5		2.5	0.5		4.0
1000 and over	0.5			1.5	1.0	3.0	6.0
Total	12.0	28.0	32.5	18.5	5.5	3.5	100.0

Source: Forms I-7, I-61

TABLE XIII-50

Distribution of Broker-Dealers
By Commissions Received from Institutional Investors
and Total Gross Income
Calendar Year 1968

Commissions Received From Institutional Investors ($000)	Total Gross Income ($000)						
	Not Available	under 100	100 to 1000	1000 to 5000	5000 to 10000	10000 and over	Total
0	6.5	15.0	6.5				28.0
under 25	3.0	8.0	17.0	5.5	1.0		34.5
25-100		0.5	5.5	4.5		0.5	11.0
100-500	0.5		1.5	10.0	3.0	1.5	16.5
500-1000	0.5		0.5	1.5	1.0	0.5	4.0
1000 and over	0.5			0.5	0.5	4.5	6.0
Total	11.0	23.5	31.0	22.0	5.5	7.0	100.0

Source: Forms I-7, I-61

TABLE XIII-51

Distribution of Broker-Dealers By Percent of Gross Income Derived
From Institutional Commissions and Exchange Membership 1/
Calendar Year 1968

Percent of Gross Income Derived From Institutional Commissions	EXCHANGE MEMBERSHIP					
	Member of NYSE	Regular Member of AMEX	Regular Member of NWSE or PCSE	Regular Member of Other Exchange Where NYSE and Amex Stocks are Dually Traded	All Others Including Non-Members of any Exchange	Total
Not Available	1.5		1.0		2.5	5.0
0	0.5		0.5	0.5	26.5	28.0
Under 5	11.0	1.0	4.0	2.0	17.5	35.5
5 - 10	8.5		2.0	1.0	2.5	14.0
10 - 15	7.0	0.5	0.5		3.0	11.0
15 - 20	1.0			1.0	0.5	2.5
20 - 25	2.0					2.0
25 and over	0.5				1.5	2.0
Total	32.0	1.5	8.0	4.5	54.0	100.0

1/ Categories of exchange membership are mutually exclusive from left to right.

Source: Forms I-7, I-61

TABLE XIII-52

Distribution of Broker-Dealers
By Percent of Gross Income Derived From Institutional Commissions
and Total Capital
Calendar Year 1968

Percent of Gross Income Derived From Institutional Commissions	Total Capital ($000)						
	Not Available	under 100	100 to 1000	1000 to 5000	5000 to 10000	10000 and over	Total*
0	6.5	15.5	5.5	0.5			28.0
under 5		7.0	17.5	8.0	2.5		35.0
5-10		1.5	5.5	4.5	1.5	1.0	14.0
10-15	5.5	2.5	2.5	3.0	0.5	2.5	11.0
15-20		0.5	1.0	0.5	0.5		2.5
20-25			0.5	1.0	0.5		2.0
25 and over		1.0		1.0			2.0
Total	12.0	28.0	32.5	18.5	5.5	3.5	100.0

*Does not include the 5.5 percent of firms for which data on total gross income were not available.

Source: Forms I-7, I-61

TABLE XIII-53

Distribution of Broker-Dealers
By Percent of Gross Income Derived From Institutional Commissions
and Total Gross Income
Calendar Year 1968

Percent of Gross Income Derived From Institutional Commissions	Total Gross Income ($000)						
	Not Available	under 100	100 to 1000	1000 to 5000	5000 to 10000	10000 and over	Total*
0	6.5	15.0	6.5				28.0
under 5		5.0	15.5	11.0	2.0	2.0	35.5
5-10		1.0	4.0	5.0	2.5	1.5	14.0
10-15	5.0	1.5	2.5	3.5	1.0	2.5	11.0
15-20		0.5	1.5			0.5	2.5
20-25				1.5		0.5	2.0
25 and over			1.0	1.0			2.0
Total	11.5	23.0	31.0	22.0	5.5	7.0	100.0

* Does not include the 5.0 percent of firms for which data on total gross income were not available.

Source: Forms I-7, I-61

2. OTC Net Trades In Stocks By Institutions

a. *Magnitude of Institutional Investor OTC Net Trades*

On stock exchange transactions a member firm must charge a brokerage commission. On many over-the-counter (OTC) transactions a broker-dealer will not act as agent for an institution, but rather as a dealer, either on a risk or a riskless basis, purchasing the stock from, or selling the stock to the institution for the broker-dealer's own trading account in anticipation of being able to turn over the position acquired to some other customer at a profit.[38] Institutional OTC net trades include transactions in both listed and unlisted stocks with market makers and others.

Banks and investment companies have the greatest volume of such OTC net trades in stocks. In 1968 the group of 47 banks and the group of 51 investment company complexes for which data are available each had net OTC stock purchases and sales of about $5 billion. Those accounts other than investment companies managed by the 28 investment advisers had more than $300 million of such transactions. The life insurance companies had about $500 million, while the fire and casualty insurance companies accounted for less than $100 million. Self-administered pension funds, college endowments and foundations combined had an additional $300 million of OTC trades.

The investment companies, investment advisers and banks trade in unlisted stocks to a greater degree than do other types of institutional investors. The OTC trading of other institutions is primarily in listed securities, the third market. Table XIII–54 shows the distribution of OTC net trades by institutional investors. Of the 29 institutional investors with OTC net trades of $100 million or more, nine were banks and 12 were investment adviser managed investment company complexes.

b. *Concentration of Broker-Dealers' OTC Net Trades with Institutions*

The number of broker-dealers that purchase securities from, or sell securities to institutions on a net basis is far smaller than the number of broker-dealers that act for them on an agency basis. For instance, although the avearge bank had a total of 212 confirming broker-dealers, only 44 of these did any dealer trading. Table XIII–55 shows the number of broker-dealers having OTC net trades with each category of institution studied. Only the banks, investment adviser-

---

[38] In a riskless principal trade the broker-dealer purchases (sells) stock only after it has found a customer on the other side to (from) whom the stock can be immediately resold (purchased) at a profit to the dealer.

managed investment company complexes and advisers' other accounts averaged OTC net trades with more than 15 broker-dealers. Table XIII-56 shows that only 46 percent of the broker-dealers had OTC net transactions with any institution. Thirty-eight percent had some net trades with banks, while 29 percent had some with investment companies. The other institutions had net trades with a very limited number of broker-dealers.

An examination of the 50 broker-dealers having the greatest volume of net trades with each class of institution (Table XIII-57) shows in somewhat greater detail the concentration of this business. Ten broker-dealers handled more than 50 percent of net trades reported by the institutions studied. The first four firms all made markets in listed as well as unlisted securities; these four accounted for $3.9 billion, or 34 percent of all institutional net trades.

The top 10 firms accounted for 50 percent of the OTC net trades with banks and 70 percent of the trades with insurance companies. Four dealers appeared among the top 10 firms for each type of institution; three of these four firms made markets in listed securities.

c. *Characteristics of Broker-Dealers With OTC Net Trades With Institutions*

Seventy-eight percent of the NYSE members in the sample (Table XIII-58) had some OTC net trades with institutions. Only 19 percent of the non-members of any major exchange received such business. Of those firms having more than $10 million in OTC net trades, 73 percent were NYSE members. Like the firms that received commission business, these firms tend to have more capital and higher gross incomes. Although only 34 percent of the firms dealing net with institutions had total capital of over $1 million, 83 percent of the firms with over $1 million in institutional net trades had at least that much total capital. Similarly, 96 percent of the firms with over $1 million in net trades had gross income of over $1 million, even though firms with that much gross income represented only 39 percent of all firms.

Table XIII-61 shows selected characteristics of the top 50 broker-dealers who do the most OTC net trading with institutions. Forty-nine of these firms made markets in unlisted securities, and eight made markets in some listed securities. Of these eight broker-dealers making markets in listed securites, six were among the 10 leading broker-dealers, including the top four. Of the $8.5 billion in institutional business done by the 50 firms, $4.8 billion or 56 percent was done by these third market makers.

TABLE XIII-54

Institutional Investors
OTC Net Trades in Stock With Broker-Dealers
1968

OTC Net Trades in Stock (millions of dollars)	NUMBER OF INSTITUTIONAL INVESTORS							Investment Company Complexes	
					Self-Administered				
	Banks	Investment Advisers	Life Insurance	Property & Casualty Insurance	Pension Funds	Foundations	Educational Endowments	Investment Adviser Managed	Insurance Company Managed
N.A.	2	9		1	1		1	6	
0					3	4	1		
under 1	4	10	6	3	1	4	7	5	2
1- 5	1	7	6	3	1		6	4	3
5- 10	6	3	4	5	3		1	7	
10- 25	10	5	5	6	2	1		7	
25- 50	4	1	4	3	2			7	
50-100	6	1				1		9	
100-250	6	1	1					5	
250-500	5							5	
500 & over	4							2	
TOTAL	48	37	26	21	13	10	16	57	5

Source-Form I-7

TABLE XIII-55

Institutional Investors

Number of Broker-Dealers Having OTC Net Trades With Institutions.
1968

Number of Broker-Dealers Having OTC Net Trades	NUMBER OF INSTITUTIONAL INVESTORS							INVESTMENT COMPANY COMPLEXES	
					SELF-ADMINISTERED				
	Banks	Investment Advisers	Life Insurance	Property & Casualty Insurance	Pension Funds	Foundations	Educational Endowments	Investment Adviser Managed	Insurance Company Managed
Not Available	6	9	1	1	1	2	1	7	
0			2	1	3	4	1		
Under 10	2	12	15	10	1	4	12	8	1
10 - 25	6	6	3	7	6		2	5	4
25 - 50	13	6	4		2			20	
50 - 75	7	3	1	1				6	
75 -100	6		1	1				1	
100 & OVER	8							10	
TOTAL (Institutions)	48	37	26	21	13	10	16	57	5
MEAN (broker-dealers)	44	22	12	15	12	2	6	32	13

Source-Form I-7

TABLE XIII-56

Concentration of OTC Net Trades With Broker-Dealers
by Institutional Investors
Calendar Year 1968

Type of Institution	Percent of Broker-Dealers With Institutional OTC Net Trades 1/
Banks	38
Investment Companies	29
Insurance Companies	7
Investment Advisers	11
Other Self-Administered Institutions	4
All Institutions	46

1/ Excludes any broker-dealer having less than $500 in such OTC Net Trades

Source-Form I-7

TABLE XIII-57

Broker-Dealer OTC Net Trades in Stocks
With Institutions

Calendar Year 1968

Top Fifty Broker-Dealers 1/	All Institutions		Banks		Investment Companies		Insurance Companies		Self-Admin. Inst.		Investment Advisers	
	OTC Net Trades (millions)	Cumulative Percent of Total	OTC Net Trades	Cumulative Percent of Total	OTC Net Trades	Cumulative Percent of Total	OTC Net Trades	Cumulative Percent of Total	OTC Net Trades	Cumulative Percent of Total	OTC Net Trades	Cumulative Percent of Total
1-10	5797	50.1	2681	50.3	2623	52.3	434	69.7	184	66.7	193	62.1
11-20	1519	63.2	604	61.6	728	66.8	51	77.9	29	77.2	30	71.7
21-30	653	68.9	231	65.8	288	72.5	24	81.7	8	80.1	21	78.5
31-40	348	72.2	110	67.9	172	76.0	12	83.6	3	81.5	10	81.7
41-50	211	74.0	76	69.1	110	78.2	6	84.6	1	81.9	5	83.3
All Other Broker-Dealers	3009	100.0	1646	100.0	1096	100.0	96	100.0	51	100.0	52	100.0
TOTAL	11571		5332		5017		623		276		311	

1/ The top fifty broker-dealers differ for the different categories of institutions.

Source-Form I-7

TABLE XIII-58

Distribution of Broker-Dealers By OTC Net Trades in Stocks With Institutional Investors and Exchange Membership 1/
Calendar Year 1968

OTC Net Trades in Stocks With Institutional Investors ($millions)	Exchange Membership 1/					
	Member of NYSE	Regular Member of AMEX	Regular Member of NWSE or PCSE	Regular Member of Other Exchange Where NYSE and Amex Stocks are Dually Traded	All Others Including Non-Members of any Exchange	Total
0	7.0		3.0	1.5	44.0	55.5
under 1	15.0	1.0	4.0	3.0	8.5	31.5
1-10	6.0		0.5		1.0	7.5
10 and over	4.0	0.5	0.5		0.5	5.5
Total	32.0	1.5	8.0	4.5	54.0	100.0

1/ Categories of exchange membership are mutually exclusive from left to right.

Source-Forms I-7, I-61.

TABLE XIII-59

Distribution of Broker-Dealers
By OTC Net Trades in Stocks With Institutional Investors
and Total Capital
Calendar Year 1968

OTC Net Trades in Stocks with Institutional Investors ($millions)	Total Capital ($000)						
	Not Available	under 100	100 to 1000	1000 to 5000	5000 to 10000	10000 and over	Total
0	9.5	25.5	17.5	3.0			55.5
under 1	1.5	2.0	13.5	10.5	3.5	0.5	31.5
1-10	0.5	0.5	1.0	4.0	1.0	0.5	7.5
10 and over	0.5		0.5	1.0	1.0	2.5	5.5
Total	12.0	28.0	32.5	18.5	5.5	3.5	100.0

Source: Forms I-7, I-61

TABLE XIII-60

Distribution of Broker-Dealers
OTC By Net Trades in Stocks With Institutional Investors
and Total Gross Income
Calendar Year 1968

OTC Net Trades in Stocks With Institutional Investors ($ millions)	Total Gross Income ($000)						
	Not Available	under 100	100 to 1000	1000 to 5000	5000 to 10000	10000 and over	Total
0	9.0	22.5	21.0	3.0			55.5
under 1	1.5	0.5	9.5	14.5	4.0	1.5	31.5
1-10	0.5		0.5	3.5	1.5	1.5	7.5
10 and over	0.5			1.0		4.0	5.5
Total	11.5	23.0	31.0	22.0	5.5	7.0	100.0

Source: Forms I-7, I-61.

TABLE XIII-61

Fifty Broker-Dealers' With Greatest Volume of OTC Net Trades in Stocks With Institutions

Calendar Year 1968

Top Broker-Dealer Dealers 1/	OTC Net Trades With Institutions ($ millions)	Number of Market-Makers		Average Number of Stocks in Which Market-Makers Regularly Made Markets		Total Dollar Volume of Trading as Market-Maker ($ million)		Gross Profits from Trading as Market-Maker ($ million)	
		OTC	3rd Market	OTC	3rd Market	OTC	3rd Market	OTC	3rd Market
1-10	5797	10	6	158	123	4565	6099	25	17
11-20	1519	10	1	156	5	11562	56	90	*
21-30	653	10	1	188	147	3957	388	32	*
31-40	348	10	-	146	-	4945	-	35	-
41-50	211	9	-	62	-	839	-	10	-

1/ Top fifty broker-dealers based on their volume of OTC net trades with institutions.

* Less than 500 thousand.

Source: Forms I-7, I-61.

3. Customer Designation of Broker-Dealers

a. *Reasons for customer designation of broker-dealers*

The bank or investment adviser managing an account is not always granted the authority to choose which broker-dealers to use in executing orders for the purchase or sale of securities. The customer, or someone other than the bank or adviser chosen by the customer, may do the trading for the account—that is, place the order with the broker-dealer. Even if the bank or adviser does the trading for the account, the order may be directed to a broker-dealer designated by the customer.

The reasons for customer designation of a particular broker-dealer are many. A person associated with the broker-dealer may be a member of the family or a friend. At times, if a broker-dealer does not provide any account management services or does not offer services suitable for a particular client, it may introduce a client's account to a bank or adviser. Executions for the client's account may then be funneled back to the introducing broker-dealer pursuant to a designation by the customer. Other broker-dealers may serve as an underwriter, or in some other investment banking relationship with an issuer corporation, and may be designated all or part of the commission business generated by an employee benefit plan of that corporation. Brokerage in some corporate accounts is directed to a certain firm because an officer of the broker-dealer serves on the board of directors of the corporation. Persons associated with broker-dealers who are alumni, or who serve as trustees, or who are large contributors to an endowment might be designated to handle the executions for those accounts.

Some firms provide performance evaluations of corporate pension funds managed by banks and investment advisers, and in return the corporation designates them to receive some of the brokerage paid by the bank or adviser managing the fund.

b. *Magnitude of customer designation of broker-dealers*

Table XIII–62 shows the percentage of various types of bank and investment adviser managed accounts for which all or part of the brokerage is designated. A much larger percentage of customers permit a bank to trade (place the order) for the account than do the customers of investment advisers. The greatest difference occurs in accounts managed on behalf of individuals. The trading for 30 percent of adviser managed individual accounts is not done by the adviser whereas only about 5 percent of the trading for bank managed personal trusts and personal agency accounts is not done by the bank.

The percentage of bank accounts for which the brokerage is not designated (free brokerage) ranges from 69 percent for personal agency accounts to 81 percent for personal trusts. The percentage of investment adviser managed accounts where there are no brokerage designations is much lower, ranging from 28 percent for both employee

53-940—71—pt. 4——55

benefit plans and non-profit organizations to 35 percent for individuals' separately managed accounts.[39]

The importance of customer designation varies from bank to bank and adviser to adviser. As much as 93 percent of the commissions paid by one bank was paid to broker-dealers designated by clients of the bank.

As shown in Table XIII-63, in 10 banks designated commissions represented 50 percent or more of the total commissions paid to broker-dealers. In another 21 banks, commissions paid to designated brokers were between 30 and 50 percent of the total. For the 46 banks where data on designated brokerage were available, customer designations accounted for $82 million, or 37 percent of total commissions paid by these banks.

Most banks claim to discourage their customers from designating the broker-dealers to be used, arguing that the designation of a particular broker for all transactions is not in the best interest of the account because no one broker-dealer can provide best execution in every instance. In some cases, banks are given discretion by their customers to use other than the designated brokers if the circumstances warrant. For instance, if a block of stock is being offered by a broker-dealer other than the one designated, the bank may usually purchase the stock for the customer's account. Other arrangements allow the bank or adviser to execute particular orders with the broker of their choice as long as a certain amount of unrelated commissions is paid to the designated broker-dealer.

c. *Importance to the broker-dealer of customer designation*

Customer designation can be a major source of bank or adviser business for any broker-dealer. Fifty percent of the broker-dealers received some bank-designated business in 1968. As shown in Table XIII-64, 18 percent of the brokers received almost all of their bank commissions solely because one or more customers had so designated. At the other extreme, 11 percent of these broker-dealers received only free commissions from the banks, and an additional 23 percent received at least 80 percent of their bank commissions in the form of free commissions.

The 50 broker-dealers receiving the greatest amount of bank-customer-designated commissions accounted for about 54 percent of such commissions. As shown in Table XIII-65, for the top 10 broker-dealers receiving designated commissions, these commissions represented 45 percent of their total bank commissions and about 1.5 percent of their gross income. All 10 of these firms are either multi-office firms doing a retail business or major investment bankers. One of these firms also offers special performance evaluation services for trust department clients. Customer-designated commissions represented 39 percent of the bank commission income of the top 50 firms as a group, and about 1.2 percent of their total gross income.

[39] For additional discussion of designation by investment adviser and bank managed accounts see ch. IV.B, and ch. V.C.4.b, respectively.

TABLE XIII-62
Customer Designation of Broker-dealers
Bank and Investment Adviser Managed Accounts

Percent of Accounts

Brokerage Designation	Bank Managed Accounts				Investment Adviser Managed Accounts		
	Personal Trust	Employee Benefit Plans	Personal Agency Accounts	Institutional Agency Accounts	Individuals Separately Managed Accounts	Employee Benefit Plans	Non-Profit Organizations
Adviser does not trade for the account	5	13	4	5	30	22	32
Over 85% of commissions are paid to broker-dealers designated by customers	12	8	23	18	36	40	34
15%-85% of commissions are paid to broker-dealers designated by customers	1	2	4	6	4	8	5
Under 15% of commissions are paid to broker-dealers designated by customers	*	*	*	*	1	2	2
No commissions are paid to broker-dealers designated by customers	81	76	69	70	35	28	28
TOTAL	100	100	100	100	100	100	100

* Less than one percent

Source: Forms I-4, I-14.

TABLE XIII-63
Commissions Paid By Banks
To Broker-Dealers Designated By Bank Customers
By Customer Designated Commissions As a Percent of Total Commissions

Calendar Year 1968

Customer Designated Commissions (thousands of dollars)	Customer Designated Commissions as a Percent of Total Commissions							
	Under 10	10 to 20	20 to 30	30 to 40	40 to 50	50 to 60	60 and over	Total
under 250	1	1	3					5
250 - 500		2	3	2	1	2		10
500 - 1,000			2	1	4		1	8
1,000 - 2,500	1	1	1	5	3	1	3	15
2,500 and over	—	—	1	2	3	1	2	9
TOTAL	2	4	10	10	11	4	6	46
Total Customer Designated Commissions (millions of dollars)	1.8	2.1	9.4	16.0	23.2	10.7	18.6	81.8

Source: Form I-7

TABLE XIII-64

Commissions Received By Broker-Dealers From Banks Upon Customer Designation as a Percent of Total Commissions Received From Banks

Calendar Year 1968

Percent of Bank Commissions Received by Broker-Dealers That Were Designated By Customers	Percent of Firms
0	11.1
under 20	23.2
20-40	13.1
40-60	26.3
60-80	8.1
80-100	18.2
TOTAL	100.0

Source: Form I-7

TABLE XIII-65
Commissions Received By Designated Broker-Dealers From 41 Banks
Calendar Year 1968

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Top Fifty Broker-Dealers 1/	Amount of Designated Commissions Received (millions)	Average Number of Banks Paying Designated Commissions	Amount of Bank Commissions Received (millions)	Col (1) as a percent of Col (3)	Gross Income (millions)	Col (1) as a percent of Col (5)	Number of Offices	Number of Registered Representatives
1 - 10	19	35.2	41	45.1	1,205	1.5	497	8,100
11 - 20	10	31.7	25	40.6	760	1.3	405	5,185
21 - 30	7	31.3	27	27.4	662	1.1	331	4,532
31 - 40	5	24.6	12	45.0	331	1.7	241	2,462
41 - 50	4	21.5	12	36.3	177	2.5	55	403
All Other Broker-Dealers	35	28.9	79	49.3	2,965	1.2	4,255	27,148
TOTAL	79		196	40.3	6,100	1.3	5,784	47,830

1/ Top fifty broker-dealers based on designated commissions received.

Source: Forms I-7, I-61

4. Execution and Clearance

Although broker-dealers may provide many services to institutional and other investors, their compensation is almost always paid in commissions or in potential trading profits.

a. *Agency executions*

The execution needs of institutional investors vary widely. Table XIII-66 shows the size distribution of orders to purchase and sell stocks through NYSE members by the major classes of institutional investors. For all institutional groups shown except investment companies, the largest percentage, ranging from 30 to 40 percent of total orders, was in the 101–999 share size, and for investment companies it was in the 1001–5000 share size. The largest percentage for individuals (39 percent) was expectably 100 shares. Those types of institutions primarily managing non-collective accounts, for example, bank trust department and non-bank trusts and estates, were more like individual investors in that over half of their orders were for 100 shares or less. Insurance companies and investment companies—totally collective accounts—have less than a sixth of their orders at 100 shares or less.

The techniques involved in the execution of smaller orders have remained basically unchanged for decades. These orders are executed on the floor of the exchange with the specialist, with orders on his book, or with another broker. The retail firms execute such orders for individual customers regularly. The large blocks, however, require a capability to search for the other side of the trade away from the regular round lot market on the floor. In the past this was done primarily by the large retail houses with the facilities to contact thousands of small customers and sell them each a part of the block. As described in detail in chapter XI, over the past several years institutional firms have sought to assemble the other side of a trade primarily among institutions rather than hundreds or thousands of small investors.

b. *Principal executions*

Trades may be executed in both the OTC and third market on either an agency or principal basis. The Study's survey of over 200 institutions revealed that more than 80 percent of the institutions, when purchasing or selling an unlisted security, will seek a quotation from a market-maker a majority of the time.

The arguments in favor of dealing directly with market-makers when purchasing or selling unlisted stocks were expressed by one bank:

> We are of the opinion that best overall results are obtainable by dealing with "market-makers" in off board securities. Market quotes, trading volume and prices of primary traders or "market-makers" are consistently better than broker-dealers in these OTC stocks. We do strive to limit these operations to financially secure, responsible dealers.

A major property and liability insurance company gave its reason for dealing directly with market-makers:

> Generally, we believe we can get a better price by dealing directly with a market-maker who we know and trust, based upon his demonstrated knowledge and expertise. In addition, we can usually be certain that our interest in

the security involved will not be revealed, at least until after consummation of the transaction. In cases where we do not have sufficient knowledge of, or confidence in, the market-maker, we may choose to be represented by another broker-dealer.

Of the less than 20 percent of institutions who did not deal with a market-maker a majority of the time, about two-fifths chose the broker-dealer without any consideration of whether or not it was a market-maker.

Those institutional investors that deliberately chose to go to an agent rather than a market-maker, usually stated their case for doing so in a matter similar to a property and liability insurance company:

If the security is traded by a comparatively small group of dealers, none of whom are known to us or if we know that they are of the type which would take advantage of our disclosing to them a sizeable trading interest, we feel that an experienced broker, who is far more familiar than we with all the "market-makers" in a given stock could obtain a sufficiently better execution to more than compensate for the resulting commission cost.

One investment adviser stated another factor in not going directly to a market-maker:

In those instances where the order placement is discretionary we attempt in some instances to compensate for investment research.

The use of brokers (or dealers acting on a riskless principal basis), rather than dealing directly with market-makers, may raise regulatory questions. This interpositioning, when done to compensate persons for the sale of mutual fund shares, has been found to constitute a fraud on the part of both the manager of an investment company and the broker-dealer who was interpositioned.[40]

It should be noted that institutions managing their own money (for example, endowments and pension funds) tend to deal directly with a market-maker less often than banks and investment advisers. The potential difficulty in justifying transactions with a broker-dealer other than a market-maker may tend to discourage the use of brokers even when not inconsistent with best execution.

The 200-plus institutions were queried as to their policy in seeking quotations from third-market-makers when dealing in listed securities. Less than one-fifth of the respondents checked third market quotations on a majority of their trades in listed securities, while about two-fifths of the institutions never checked the third-market.[41] The advantages of dealing with third-market market-makers were enumerated by one life insurance company to be:

Block size, direct negotiation of price between three parties, lower cost, known price at which trades will be accomplished, more rapid stock delivery and no "partial" deliveries, and lack of affect of order on exchange markets.

---

[40] In *Delaware Management Company, Inc.*, the principal issue involved interpositioning in the execution of portfolio transactions for mutual funds. Delaware Management Co., a registered broker-dealer, was the investment adviser of and principal underwriter for two mutual funds and its officers were the officers of the funds. It interposed a second broker-dealer, which did not maintain markets in listed or unlisted securities, between the funds and the best market in order to compensate the second firm for selling the funds' shares and to stimulate further sales. It was established that the funds were in a position to deal directly with the same broker-dealers used by the interposed broker on as favorable a basis. As a result, the funds were caused to incur unnecessary brokerage costs and charges. The Commission concluded that this practice constituted a fraud on the funds and their shareholders by both broker-dealers and their principals. Securities Exchange Act Release No. 8128 (July 19, 1967).

[41] Quotations of some third-market market-makers are available to institutional investors subscribing to the Autex Block Information System. In addition, some third market-makers' quotes are shown anonymously on Instinet. For a description of these systems see ch. XI.

An investment adviser pointed out the potential savings in commissions:

A "third market" market-maker may offer a better net price (after taking into account commissions) than a trade on a securities exchange. Consequently, in almost every instance we obtain a competitive quote from one or more "third market" market-makers before placing an order.

While some have contended that the lack of a tape print has advantages, one bank, concerned about its fiduciary responsibilities, pointed out the disadvantage of not having a tape print:

The "third market" consistently utilizes the "exchange last sale" as its basis for trading smaller increments of stock. Since the last sale is obviously history, there is absolutely no way to determine if an execution is good or bad until judged in retrospect. We feel we cannot come under criticism for an execution on a regulated exchange if the order has been handled with care and intelligent thought. Conversely, we could be criticized for executions which cannot be substantiated by a print. We do utilize the "third market" for larger block transactions or thinly traded stocks, particularly utilities.

Most others cited the inability of the third market to handle large trades or the importance of using the auction market for small trades as reasons for not getting quotes. A bank responded:

In terms of the total number of separate trades executed, most trades made on behalf of customers of our institution are of a very small size. The major exchanges are very important for such orders because they provide a regular and dependable market. Usually, the advantages of continuity and dependability provided by the major exchanges outweigh the price difference for such small orders which the third market can sometimes provide. However, where larger orders are involved so that the price difference which the third market may offer can be meaningful in terms of total dollars, our institution does seek quotations in the third market and trades in that market where in our judgment it offers the more advantageous execution from an overall standpoint.

An investment adviser explained its position as follows:

In a majority of instances, quotes from the third market are not sought since the supply of stock they ordinarily are willing to bid or offer is insignificant in terms of the size of the order that our institution must execute. In those circumstances where it is believed that circumstances exist so that the third market may be able to bid or offer a sufficient quantity of securities without entering the other markets to obtain a sufficient supply to meet our needs, the third market is consulted and may be used later.

As pointed out above and in the later section on reciprocity [42] some institutional investors such as banks and investment advisers have an incentive to *create* commissions when trades could actually have been done at net prices. This is to take advantage of certain services being offered by the non-market-making broker-dealers. Some banks, on the other hand, trade directly with the market-makers at net prices and add a charge equal to the commission which would have been charged had the bank given the order to a non-market-making broker-dealer. This charge is retained by the bank. At least six of the 50 banks studied charged a full NYSE commission on net trades; at least two others charged half of a NYSE commission. These charges are not imposed on trust accounts, but are imposed on agency and custody accounts. The amount of income to the banks from these charges was almost $6 million in 1968 and 1969, but one bank alone collected more than $3.5 million of this total.

[42] See sec. C.7, *below*.

c. *Trading discretion given to broker-dealers*

When an institution places an order to buy or sell securities with a broker-dealer, the broker-dealer may be given varying amounts of trading discretion. At one extreme an institution might authorize an individual broker-dealer to dispose of an entire position as it sees best. At the other extreme, the institutional trader may "mastermind" the trade by feeding out orders as he thinks they can best be handled in the market and by directing the broker-dealer to sell each portion of the block at the time and in the market the institutional trader deems best. In reality most institutional trading fits somewhere between the two extremes.

The Study's survey of over 200 institutions sought to determine the extent of discretion granted to the broker-dealer by the institutional investor. The institutions were asked how frequently broker-dealers are given discretion to govern the timing of individual transactions in effectuating a single investment decision. About 3 percent of the institutions responded "always," while almost two-fifths of the institutions answered "never." One-third only "occasionally" granted the broker-dealer such discretion, while almost one-fifth said that they "ordinarily" did.

Once a decision has been reached as to when transactions should be executed, a marketplace must be chosen. It must be noted, however, that the choice of broker-dealer determines to a great extent the market to be used in executing the order. For instance, when the institution places an order with a member of the NYSE there is little chance of execution elsewhere but on that exchange or, if the NYSE member is also a member of a regional exchange, on a regional. In the SEC Rate Hearings, the then Chairman of the Board of Governors of the NYSE stated: ". . . when an institution gives me the order, he expects me to execute on the floor of the New York Stock Exchange. He does not expect me to go to the third market." [43] Similarly, the likelihood that an institution would give an order to a third market market-maker in anticipation of his going to the NYSE is very slight. When the institutions were queried as to granting discretion in choice of the executing market, about half responded they "always" or "ordinarily" gave such discretion, and an additional quarter "occasionally" did.

Discretion as to the price of an individual transaction was given to the broker-dealer far less frequently than discretion as to choice of market. In most instances, an institutional investor will either place a price limit on the order, or will ask the broker-dealer to check back after finding the other side but before executing the transaction. Only 3 percent of the sample institutions "always" gave price discretion, with an additional one-fifth of the institutions responding "ordinarily." More than two-fifths of these institutions, however, granted such discretion only "occasionally."

d. *Clearance and settlement*

Clearance and settlement is the process of delivering securities from the seller to the purchaser and the cash payment from the purchaser to the seller. Unlike most business transactions, where purchaser and seller consummate a transaction in each other's presence or at least

[43] SEC Rate Hearings, at 5115.

with knowledge of each other's identity, most securities transactions are handled by agents representing undisclosed purchasers and sellers.

Under normal circumstances, the purchaser and seller of a security have five business days to deliver the cash and certificate, respectively, to their brokers. On the fifth business day after the transaction the two brokers must settle the transaction.[44]

By use of a C.O.D. account with a broker or a bank, however, it is possible for an institutional investor to withhold payment for securities until the certificates are actually received by the institution.[45] But, although the broker on the other side of a purchase transaction has not delivered the security, the purchaser has a contract giving to it the benefits and risks of ownership, even though it has not yet paid any consideration. Banks, when acting as both manager and custodian for an account, will generally liquidate any short-term holdings prior to or on the fifth business day after execution of the order to free the cash needed to pay for delivery. If the securities are not promptly delivered, the bank, not the account for which it has acted, will have the direct benefit of the cash float.[46] Bankers interviewed by the Study generally stated that it would be too complex and costly a bookkeeping procedure to keep their accounts fully invested beyond the scheduled delivery date. When a bank acts as custodian for other institutions they usually receive the benefits of the cash which remains at the bank awaiting receipt of the securities. Several of the largest institutional investors using bank custodians, however, have worked out arrangements to enable them, and not the bank, to receive the advantages of the float resulting from the failure of a broker to complete delivery of securities purchased by them.

During the period of the fail, the cash is invested in other securities, for example, short-term notes. The institution thus receives the benefits of owning $2 worth of securities but has an outlay of only $1. Unlike margin accounts, this is accomplished without borrowing or paying any interest on the other dollar.

Broker-dealers contend that many of these fails are the fault of the institutions or their custodians, and not themselves. In some instances the fault lies with the custodian who rejects a delivery because its records are in error. In other instances the fault lies with the institutional customer who has not promptly notified the custodian of a trade and no delivery is expected. This problem is complicated by the refusal of some institutions or their custodians to accept partial delivery of an order. Thus, the broker-dealer would not receive cash for that portion of an order for which he could make delivery.

A report prepared for the American Stock Exchange had the following findings about fails:

> This problem is aggravated by the lack of incentive for an efficient flow. For example, if an institutional investor fails to issue adequate, timely instructions

---

[44] Interbroker settlements are usually handled through the facilities of a stock exchange clearing corporation. As part of the clearing process used by the NYSE and Amex, transactions are netted among all clearing broker-dealers and the brokers representing the purchaser and seller in an individual transaction might not be settling the transaction among themselves, but rather with other brokers not involved in the particular transaction.

[45] C.O.D. transactions are permitted under FRB Reg. T, 12 C.F.R. § 220.4(c)(5).

[46] One bank, in its 1969 Annual Report, attributed part of an increase in interest earned on invested assets to the increase in "funds available for investments [which], continued to reflect the slow clearance of securities transactions on Wall Street." For a further discussion of the value of such floats to banks and their impact on fees, see ch. V. H.

to a custodian bank or receiving agent to receive certificates which he has purchased, the bank will not accept the certificates, and will not pay the delivering broker. The result in this case is that the institution has use of its funds for a period beyond this settlement date, but the buying broker has had to pay the selling broker when the shares are delivered. Thus, some have use of pools of money created by blockages in the system, while other parts of the industry have to bear higher costs.

In studying this problem, the NR team found that approximately 25 percent of broker deliveries to New York receiving agents were being rejected. The reason for three-fourths of these rejections was because the receiving agent did not have specific instructions from his customers to accept the delivery. A further survey showed that some 20 percent of the customer instructions were not arriving at the receiving agent until after the settlement date. On a C.O.D. (cash on delivery) settlement, several million dollars may thus be available to the buying institution for several more days. This availability can be tremendously profitable. And throughout the entire system there is an incentive to deliver out but no incentive to actually receive certificates. It is interesting that no one wants certificates; what they want is cash. [47]

Some institutional investors have attributed part of the failure to receive instructions to a breakdown in communications between out-of-town custodians and their New York correspondent receiving agents.

During the last half of the 1960's the volume of fails to deliver grew at a rapid rate. At the beginning of 1965 the value of all securities failed to deliver by NYSE member firms was $400 million. By the end of 1968 fails rose to over $4.1 billion. Since then the value of fails has declined and for most of 1970 has been under $1 billion.

Numerous steps have been taken by the securities industry to combat the problem of fails. Among those which affect institutional investors was a rule adopted by the NYSE which requires member firms to take orders only from customers willing to accept and pay for partial deliveries.[48] The NYSE has informed the Study that to date the rule has not been very effective but no action by the Exchange has been taken against any firm for violating the rule. A study by the Rand Corporation found that the costs to broker-dealers of completing securities transactions could be reduced by more than one-third if partial deliveries were accepted by C.O.D. accounts.[49]

The Banking and Securities Industry (BASIC) has circulated for discussion certain proposed changes in procedures for the handling of C.O.D. accounts.[50] Three major recommendations would require C.O.D. customers to isue standing instructions to agent banks to receive securities against payment on the basis of confirmations from brokers previously specified by the customer. According to BASIC there are arguments for and against this procedure:

Those advocating the standing instruction procedure argue that it is the only way to make the COD DK problem disappear; that Regulation T of the Federal Reserve Board should make the issuance of standing instructions a condition precedent to use of the COD privilege; and that the knowledge that transactions will settle based upon brokers' confirmations will spur customers to see that fast communication means are used to detect and correct errors in confirmations prior to settlement dates.

---

[47] North American Rockwell, *Securities Industry Overview Study*, at 32.

[48] NYSE, rule 430.

[49] Oral presentation by the Rand Corp. to the Commission entitled, *Reducing cost of Incomplete Stock Transactions: A Study of Alternative Trade Completion Systems* (July 14, 1970).

[50] *Reducing the Rejections of Deliveries Against Payment Because of Lack of Instructions ("DK's" on COD Deliveries), Discussion Paper* (Dec. 1, 1970).

The objections raised against standing instructions to banks to pay for securities delivered on the basis of brokers' confirmations turn on the errors in brokers' confirmations: duplicate deliveries; wrong price, quantity, customer, or even wrong side of the trade; incomplete or inaccurate information as to sub-account data; delivery to the wrong bank; etc. Customers argue that they are unwarrantedly exposed to loss if an instruction is standing to settle on the basis of confirmations when the latter can and do contain errors like these—that the risk is too great that they will be unable to secure the erroneous confirmation and get it corrected in time to prevent incorrect settlements.

Some agent banks also raise questions about a universal standing instruction procedure. They point out that the customer selects the broker and that all responsibility for a trade, and for errors in a broker's confirmation thereof, lies between those two parties. Yet, if agent banks settle unwittingly on the basis of an erroneous confirmation, they say that they are drawn into the ensuing controversy. This is particularly true where there are allegations that the customer alerted them to an error in a confirmation.[51]

---

[51] *Id.*, at 6.

TABLE XIII-66

Distribution of Share Size of Orders to Purchase or Sell Stocks
NYSE Members
1969

Size of Order (shares)	Commercial Banks and Trust Companies	Investment Companies	Life Insurance Companies	Non Life Insurance Companies	Pension Funds	Non-Bank Trusts and Estate	Individuals
Odd Lot	28.7	4.4	5.4	12.2	12.8	29.8	33.5
100	21.8	10.1	11.3	25.5	26.2	24.9	39.0
101 - 999	30.0	31.3	40.4	39.7	42.0	38.0	25.2
1000	3.1	8.7	10.0	7.6	4.4	3.1	1.4
1001 - 5,000	6.8	32.9	24.5	11.7	12.1	3.5	0.8
5001 -10,000	9.0	6.8	6.2	2.4	1.9	0.5	0.1
Over 10,000	0.6	5.8	2.2	0.9	0.6	0.1	0.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: Unpublished data of NYSE 1969 Transaction Revenue Survey.

(Readers and Revisers Carry All Information Prominently)

5. Institutional Investor Payments for Research

One of the major services provided by broker-dealers is investment research. Such research may take many forms including analyses of the entire economy, the market, specific industries and individual companies.

a. *Magnitude of institutional investor payments for research*

The percentage of institutional investor commissions paid out for research varies among and within institutional categories. The magnitude of such payments vary with two factors: one, the amount of research needed to supplement that produced by the institution itself; and two, the institution's alternative uses for the commissions generated.

Banks and investment companies, appear on the average to pay only a relatively small percentage of their total commissions for research services. Table XIII–67 shows the amount of commissions reported by 46 banks to have been allocated for research. Eleven of the banks paid out under $100,000 in commissions for research. For 10 of these 11 banks, this amount represented less than 20 percent of their "free" commissions. At the other end of the scale, 11 banks paid out at least $500,000 in commissions for research; for eight of them, this amount was less than 20 percent of their free commissions. The two banks paying the greatest amounts accounted for more than a fourth of the total commissions paid by the banks for research. The median percentage of free commissions paid by the banks for research in 1968 was 13.3 percent. The banks as a group spent $14.6 million, or 12.2 percent of their $137 million in free commissions for research.

Table XIII–68 shows that investment advisers managing the largest investment company complexes reported allocating a considerably larger proportion of their total commissions for research than reported by banks. Of the 49 complexes, 31 paid out at least $500,000 in research commissions. In only nine of the 31 was this amount less than 20 percent of their commissions. Sixteen of the complexes paid out at least $1 million in commissions for research. As a group these 49 investment company complexes paid out $58.3 million, or 23.1 percent of their $252.1 million in commissions for research. The median investment company complex paid out 27.3 percent of its commissions for research.

Insurance companies and other self-administered institutions that do not have many alternative uses for these commissions generally pay out much more of their commissions to broker-dealers providing research than do the banks and investment advisers. In some instances these institutions will pay out substantially all of their commissions to firms providing research services. It is difficult to quantify what most of these institutions would pay for research if alternative uses for commissions were available.

A senior vice-president of one of the largest life insurance companies explained that at the beginning of each year his company prepared a budget detailing the amount of commissions each brokerage firm

should receive in return for the research to be provided. Because most of the commissions paid by this company went to the research firms, at the end of a few months the budgeted commissions were already paid. Rather than pay the additional commissions to other firms from whom this company received no research or unsatisfactory research, it continued to pay commissions to the same research firms, basically in the same ratio as the budgeted amounts. In 1968 these firms on the average received between five and six times the commissions they had been budgeted to receive.

b. *Concentration of research commissions*

Investment company complexes pay research commissions to a much larger number of broker-dealers than do banks. Table XIII-69 shows the number of broker-dealers reported by banks and investment company complexes to have been paid commissions for research. While only 4 percent of the large banks paid commissions for research to more than 100 broker-dealers, 34 percent of the investment company complexes paid research commissions to that many firms. In 1968 the investment company complexes paid commissions for research to an average of 88 broker-dealers, and the banks to an average of 49.

Table XIII-70 and XIII-71 show for the investment company complexes and banks, respectively, the research commissions paid to the 50 firms receiving the largest amount of such commissions from each group. The top 10 firms received 25 percent of all investment company research commissions and 33 percent of the commissions banks paid for research. The top 50 firms received 66 percent and 75 percent of the research commissions paid by the investment company complexes and the banks, respectively.

The top 10 research firms received commissions on the average from more than 35 of 41 banks providing data, but received research commissions from only 33 of 49 investment company complexes for which data were available. After the first 10 firms the number of banks from which a firm received commissions drops off continuously, falling to an average of 15 banks for the 41st to 50th firms. The 50 firms dealt with an average of 23 banks each. The number of investment company complexes paying research commissions remained fairly level for the 50 firms, declining from a high of 33 for the first 10 firms to an average of 29 for the 41st to 50th firms.

A large range was reported to the Study both in the number of banks paying research commissions to each of the leading research broker-dealers and in the amount of commissions received by them from each bank. The research broker-dealers in the top 10 received commissions from an average of about $90,000 more from 20 additional banks than the broker-dealers in the 41 to 50 group. Two-thirds of the 335 percent difference between the one to 10 and 41 to 50 groups of research firms serving investment companies is primarily attributable to the amount of commissions received from each complex and not the number of complexes from which research commissions are received.

c. *Importance of research commissions to broker-dealers*

For all broker-dealers, commissions received for research represent about 22 percent of the free commissions from banks and 33 percent of

the total commissions from investment companies. About 1.4 percent of the total gross income of broker-dealers comes from these two sources combined. The research commissions paid to the top 10 firms accounted for 46 percent of total commissions received by them from investment company complexes and 32 percent of free commissions received by them from banks.

d. *Research expenses of broker-dealers*

In 1968 NYSE member firms had research expenses attributable to their commission business (exclusive of compensation to general partners and voting stockholders) of $79.4 million. This was equal to about 2.9 percent of their $2.7 billion security commission expenses. Their total research expenses of $97.1 million was equal to 2.4 percent of their total expenses of $4.0 billion.

Tables XIII–72 and XIII–73 show, for NYSE member firms, the distribution of research expenses by their average commission income per transaction. These tables show that firms dealing primarily with institutional investors (commission income per transaction of $100 and over) incur greater research expenses, both absolutely and in relation to total expenses, than do firms dealing primarily with the public (income per transaction under $50). The median income per transaction for all firms was $43.37. The groups of firms with research expenses of $100,000 and over all had median incomes above the median for all firms, while the groups of firms with under $100,000 in research expenses all had median incomes below the median for all firms. While the median research expense per firm was $60,000, the median for the institutional firms was more than double that, $129,000. Security commission research expense for the median institutional firm was 3.3 percent of total expenses but only 1.0 percent for retail firms and 1.4 percent for all firms.

The research expenses incurred by the institutional firms equaled 22 percent of total research expenses for the industry even though these firms accounted for only 14 percent of security commission income.

53-940 O - 71 - pt. 4 - 56

TABLE XIII-67
Commissions Paid by Banks for Research
by Research Commissions as a Percent of Free Commissions

Calendar Year 1968

Commissions Paid For Research (thousands of dollars)	Research Commissions as a Percent of Free Commissions1/						
	under 5	5 to 10	10 to 15	15 to 20	20 to 30	30 and over	Total
Under 100	2	4	2	2		1	11
100 to 200		3	2	1	2		8
200 to 300	1	2	2	1	1		7
300 to 400	1				3	1	5
400 to 500			1			3	4
500 to 750	2	1	2	1		2	8
750 and over	—	—	2	—	1	—	3
TOTAL	6	10	11	5	7	7	46

1/ Free commissions are total commission paid less those commissions paid to broker-dealers upon the designation of customers.

Source: Form I-7.

TABLE XIII-68
Commission Paid by Advisers to Investment Company Complexes
by Research Commissions as a Percent of Total Commissions

Calendar Year 1968

Commissions Paid For Research (thousands of dollars)	Research Commissions as a Percent of Total Commissions						
	0 to 10	10 to 20	20 to 30	30 to 50	50 to 70	70 and over	Total
under 250	3	1	2		1	4	11
250 to 500	2	3		1	1		7
500 to 750		1	2	2		1	6
750 to 1,000	1	2	3	1	2		9
1,000 to 2,000			4			1	5
2,000 and over	—	5	1	—	3	2	11
TOTAL	6	12	12	4	7	8	49

Source: Form I-7.

TABLE XIII-69

Number of Broker-Dealers
Paid Commission for Research
1968

Number of Broker-Dealers Allocated Commissions For Research	Number of Banks	Number of Investment Adviser Managed Investment Company Complexes
0 - 20	6	3
21 - 40	14	9
41 - 60	13	1
61 - 80	7	9
81 - 100	4	11
101 - 150	2	11
151 and over		6
TOTAL	46	50

Source: Form I-7

TABLE XIII-70

Commissions Received By Broker-Dealers For Research
From Investment Company Complexes
Calendar Year 1968

Broker-Dealers 1/	(1) Total Amount of Research Commissions Received (000)	(2) Average Number of Investment Company Complexes Paying Commissions For Research	(3) Research Commission Income Received Per Investment Company Complex (000)	(4) Total Amount of Investment Company Commissions Received (000)	(5) Col. (1) As A Percent of Col. (4)	(6) Total Gross Income (000,000)	(7) Col. (1) As A Percent of Col. (6)	(8) Total Number Professional Research Employees	(9) Total Other Research Employees	(10) Research Income From Investment Companies Per Professional Employee (000)
1-10	14,780	32.8	451	32,460	45.3	534	2.8	26.6	16.5	56
11-20	8,260	32.0	258	28,590	28.9	330	2.5	19.9	15.2	42
21-30	6,760	31.7	213	19,140	34.8	883	0.7	28.6	39.7	24
31-40	5,110	30.2	169	22,260	23.0	431	1.2	18.4	13.0	28
41-50	3,990	28.9	138	14,330	27.8	316	1.3	14.6	14.5	27

1/ Top fifty based on research commissions received from investment company complexes.

SOURCE: Forms I-7, I-61

TABLE XIII-71

Commissions Received By Broker-Dealers For Research From Banks
Calendar 1968

Broker-Dealers[1/]	(1) Total Amount of Research Commissions Received (000)	(2) Average Number of Banks Paying Commissions for Research	(3) Research Commission Income Received Per Bank (000)	(4) Total Amount of Free Banks Commissions Received (000)	(5) Col(1) as a percent of Col(4)	(6) Total Gross Income (000,000)	(7) Col(1) as a percent of Col(6)	(8) Total Number of Professional Research Employees	(9) Total Other Research Employees	(10) Research Income Per Professional Research Employee (000)
1 - 10	5,410	35.0	155	16,840	32.1	575	2.9	25.7	18.7	21.0
11 - 20	2,990	26.4	113	10,210	29.3	362	0.8	18.9	21.7	15.8
21 - 30	1,770	21.4	83	15,320	11.6	889	0.2	31.9	36.2	5.6
31 - 40	1,210	19.4	62	8,860	13.7	487	0.2	21.9	14.3	5.5
41 - 50	970	15.1	64	6,190	15.7	195	0.5	11.8	9.4	8.1

1/ Top fifty based on research commissions received from banks.

Source: Forms I-7, I-61.

TABLE XIII-72

Research Expenses
By Commission Income Per Transaction
NYSE Member Firms
1968

(a)

Commission Income Per Transaction (dollars)	SECURITY COMMISSION RESEARCH EXPENSE ($000)							
	0	Under 50	50 to 100	100 to 200	200 to 500	500 to 1000	1000 and over	TOTAL
Under 50	22.8	29.1	17.5	14.1	8.3	4.2	4.2	100.0
50 to 100	16.1	31.2	8.6	16.1	10.8	13.0	4.3	100.0
100 and over	17.3	9.6	11.5	21.2	17.3	13.5	9.6	100.0
TOTAL	20.5	26.9	14.5	15.5	10.1	7.5	4.9	100.0
MEDIAN INCOME PER TRANS ($)	38.75	41.14	40.63	46.17	48.26	68.97	47.39	43.37

(b)

Commission Income Per Transaction (dollars)	SECURITY COMMISSION RESEARCH EXPENSE ($000)								
	0	Under 50	50 to 100	100 to 200	200 to 500	500 to 1000	1000 and over	TOTAL	MEDIAN RESEARCH EXPENSES ($000)
Under 50	69.6	67.3	75.0	56.7	51.3	34.5	52.6	62.4	45
50 to 100	19.0	27.9	14.3	25.0	25.6	41.4	21.1	24.1	71
100 and over	11.4	4.8	10.7	18.3	23.1	24.1	26.3	13.5	129
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	60

Source: NYSE Member Firm Income and Expense Reports: 1968.

TABLE XIII-73

Security Commission Research Expenses as a Percent of Total Expenses
By Commission Income Per Transaction
NYSE Member Firms
1968

(a)

Commission Income Per Transaction (dollars)	SECURITY COMMISSION RESEARCH EXPENSE AS A PERCENT OF TOTAL EXPENSES								
	0	Under 1	1 to 2	2 to 3	3 to 4	4 to 5	5 to 10	10 and over	TOTAL
Under 50	22.8	22.4	25.7	12.9	6.6	2.5	2.5	0.4	100.0
50 to 100	16.1	10.8	18.3	17.2	12.9	7.5	8.6	5.4	100.0
100 and over	17.3	13.5	11.5	5.8	9.6	7.7	17.3	17.3	100.0
TOTAL	20.5	18.4	22.0	13.0	8.5	3.9	6.0	3.9	100.0
MEDIAN INCOME PER TRANS ($)	38.75	38.58	40.34	47.02	50.31	54.10	55.54	103.58	43.37

(b)

Commission Income Per Transaction (dollars)	SECURITY COMMISSION RESEARCH EXPENSE AS A PERCENT OF TOTAL EXPENSES									MEDIAN RESEARCH EXPENSE %
	0	Under 1	1 to 2	2 to 3	3 to 4	4 to 5	5 to 10	10 and over	TOTAL	
Under 50	69.6	76.1	72.9	62.0	48.5	40.0	26.1	6.7	62.4	1.0
50 to 100	19.0	14.1	20.0	32.0	36.4	53.3	34.8	33.3	24.1	2.3
100 and over	11.4	9.9	7.1	12.0	15.2	26.7	39.1	60.0	13.5	3.3
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	1.4

Source: NYSE Member Firm Income and Expense Reports: 1968.

6. Other Services Offered to Institutional Investors

In addition to execution and research, broker-dealers offer other related services to institutional investors, including portfolio valuation, custody of securities, financing of margin accounts and communications.[52]

a. *Portfolio valuation*

Most institutional investor portfolios are valued at intervals varying from twice daily for some mutual funds to once a year for some bank managed personal trusts.[53] Often the entire job of valuing these portfolios, or sometimes just supplying the price data, is handled by a broker-dealer. In addition, some broker-dealers offer services which measure the performance of portfolios managed by the institutional investor. Nineteen of the banks reported that they received portfolio valuation services from one or more broker-dealers. Of 57 advisers to investment company complexes, 34 received these services. Such services are little used by insurance companies and the self-administered institutions; only eight of 47 insurance companies and four of 39 self-administered institutions reported their receipt.

b. *Custody of securities*

The custody and safekeeping of securities by broker-dealers, although available to most institutional investors, is a service that few institutional investors use. Most institutional investors prefer bank custodians. With the exception of four investment company complexes, one insurance company and one college endowment, the advisers to non-investment company accounts were the only institutional investors

[52] The NYSE has interpreted its anti-rebate rule to permit its members to perform certain services without violating those rules. The offering of some services, however, has been declared in violation of the anti-rebate rule. A member firm can use its computer to calculate the value of a customer s portfolio but it cannot let the customer use the computer for another purpose, e.g., preparing a payroll. A member can take a customer out to dinner but he cannot pay for a dinner which he does not attend. *See, e.g.,* SEC Rate Hearings, 80–116.

[53] See ch. IV.B. and ch. V.D.4.

paying commissions to any broker-dealer that had custody of a substantial amount of their portfolio. New advisory accounts are frequently set up with custody in the broker-dealer that is to receive designated business.

c. Margin accounts

Margin trading is done primarily by individual rather than institutional investors. As shown in Table XIII–74, all major institutional investor categories as a group accounted for only about 15 percent of the dollar value of all margin trading in 1969. More than half of the 15 percent was attributable to hedge funds. Mutual funds accounted for 20 percent of institutional margin trading and commercial banks for another 18 percent. According to unpublished data collected by the NYSE for its latest Public Transaction Study, total margin trading by these institutions represents only 2.8 percent of their total trading. The importance of this activity to broker-dealers appears to be negligible.

d. Communications

A major service supplied by the broker-dealers to institutional investors is free communication facilities, usually in the form of a direct telephone wire. Table XIII–75 shows the number of broker-dealers with whom institutional investors have direct wires. Most investment companies and banks have direct wires to one or more broker-dealers, however, only a small minority of the other institutional investor categories have any direct wires. Since installation of these wires can be expensive, they are cost-justified to the broker-dealer only if an institution generates a substantial commission volume.[54] Direct wires to institutions are only part of the total leased wire costs of $32 million for NYSE members in 1968. This $32 million represents less than 1 percent of total expenses for NYSE member firms.

---

[54] If a broker-dealer thinks that the cost of a direct wire with certain institutions is not cost justified, he can, within the rules of the NYSE, accept "collect" telephone or wire messages.

TABLE XIII-74

Margin Trading - All Markets

Relative Importance of Customer Groups
1969

Customer Group	Percent of Total Value of Margin Trading: All Investors	Percent of Total Value of Margin Trading: Institutional Investors
Commercial Banks	2.7	18.2
Mutual Funds	3.0	20.3
Hedge Funds	7.6	51.4
Pension Funds	0.4	2.7
Life Insurance Companies	0.1	0.7
Non-Life Insurance Companies	0.3	2.0
Non-Bank Trusts	0.7	4.7
Sub-Total	14.8%	
All Other	85.2	
Total	100.0%	100.0%

Source: NERA, "Stock Brokerage Commissions: The Development and Application of Standards of Reasonableness for Public Rates," Vol. II, July 1970.

TABLE XIII-75

Institutional Investors
Number of Broker-Dealers with Whom
They Have Direct Wires
1968

	NUMBER OF INSTITUTIONAL INVESTORS							
Direct Wires To Broker-Dealers	Banks	Investment Advisers	Life Insurance	Property & Casualty Insurance	Self-Administered Pension Funds	Foundations	Educational Endowments	Invesmtment Company Complexes
0	3	7	19	13	4	5	7	
1- 20	18	4	4	5	2	1	1	20
21- 40	9							4
41- 60	6							2
61- 80	6							
81-100	4							
over 100	1							12
TOTAL	47	11	23	18	6	6	8	38

Source: Form I-7

7. Reciprocity

a. *Introduction*

Reciprocity, the purchasing of products or services from those persons who purchase your products or services, is a common form of business behavior:[55]

> Reciprocal buying is economically significant when a firm can make sales in this way that it could not otherwise make or could make only at greater costs. It is a characteristic of imperfectly competitive markets . . .
> Reciprocal buying is essentially a selling technique in markets of imperfect competition.[56]

The importance of reciprocity to the securities industry has been analyzed and widely discussed in the past. In a survey conducted in 1962, the Special Study found that banks frequently mentioned commercial deposit balances and loans as a reason for allocating commissions to individual brokers. In addition, tenancy of a broker-dealer in a bank building and his referral of commercial business (for example, transfer agencies and registrarships) were mentioned as factors in the allocation of commissions.[57] Mutual funds cited the sale of shares of the fund as a major reason for allocating commissions to a broker-dealer. [58] Purchase of insurance, however, did not appear to be a significant factor in the allocation of insurance commission business.[59]

A Study of Mutual Funds prepared for the Commission by the Wharton School of Finance and Commerce found:

> The sale of mutual fund shares by broker-dealers is the most important factor affecting the brokerage allocations of the numerous open-end company groups selling their shares in volume through independent dealers.[60]

The Commission made a similar finding in its 1966 Mutual Fund Report:

> The managers of most dealer-distributed funds which are not closely affiliated with brokerage houses use a substantial portion of the funds' brokerage to pay dealers extra compensation for sales of fund shares. The amount of brokerage available for sales depends upon a variety of factors, but generally the larger funds and fund complexes are able to use a much greater percentage of their brokerage for sales than are the smaller ones.[61]

The Federal Trade Commission has stated that reciprocity as a course of business with respect to products,

> . . . transforms substantial buying power into a weapon for "denying competitors less favorably situated access to the market". It distorts the focus of the trader by interposing between him and the traditional competitive factors of price, quality and service an irrelevant and alien factor which is destructive of fair and free competition on the basis of merit. The efficient producer may thereby suffer loss because of a circumstance extrinsic to the worth of his product.[62]

Additional complications arise in the securities industry since reciprocal practices may conflict with the fiduciary relationship between

[55] In a 1961 survey of 300 purchasing agents of industrial companies, 78 percent responded that reciprocity was a factor in their purchase-selling decisions. In certain industries, including chemicals, petroleum and iron and steel, 100 percent of those queried attested to the importance of reciprocity in their decision-making process. Sloane, *Reciprocity: Where Does the P.A. Stand?* 70, 76–77 (November 20, 1961).

[56] Stocking and Mueller, *Business Reciprocity and the Size of Firms*, 30 J. Bus. 75 (1957).

[57] Special Study at 859–861.

[58] *Id.*, at 862–863.

[59] *Id.*, at 862.

[60] H.R. Rep. No. 2274, 87th Cong., 2d Sess. 32 (1962).

[61] SEC, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 15 (1966) "Mutual Fund Report."

[62] *In the Matter of Consolidated Foods Corporation*, 62 F.T.C. 952 (1963).

the money manager and his beneficiary. The Commission has pointed out potential problems of reciprocal arrangements in the mutual fund industry at the fund management level:

The increasing importance of brokerage as compensation for sales of fund shares presents a potential for harmful effects on fund management. The need to allocate brokerage for sales may tempt fund advisers to skimp on the allocation of brokerage for investment advice or other nonsales services of greater benefit to the funds than the accelerated sales of new shares. Even more important, it creates pressures for "churning", i.e., frequent sales and purchases of portfolio securities unwarranted by investment considerations for the purpose of generating brokerage commissions. It can lead fund managers to eschew those markets where the best prices in portfolio transactions might have been obtained and may cause them to pay unnecessary charges for the execution of such transactions. Thus, mutual funds have made appreciably less use than other institutional investors of the third market, which has no minimum commission schedule and therefore cannot provide give-ups.[63]

The Commission also pointed out potential dangers at the broker-dealer level:

Mutual fund reciprocal and give-up practices also may impair the integrity of dealer recommendations upon which customers rely. They operate as hidden influences by tempting dealers to base their recommendations on the amount of brokerage and give-ups received rather than on the investment needs of their customers. . . . It places small funds and fund complexes, which cannot allocate as much brokerage for sales as larger ones, at a distinct disadvantage in competing for dealer favor.[64]

At least one of the questions arising from the use of reciprocity by mutual funds also holds for other institutional managers: does reciprocal income received by the manager, when added to the management fee, lead to excessive compensation? In banking, additional questions unrelated to fiduciary duty arise, for example, whether reciprocal arrangements may be circumventing legal restrictions applicable to the payment of interest of deposits.

b. *Bank commission payments to broker-dealers with commercial relationships*

The Study has sought to determine the extent of commercial relationships between broker-dealers and banks and the extent these relationships affect the allocation of brokerage commissions.

The existence of a deposit relationship with a bank strongly enhances the possibility that a broker-dealer will receive commissions from that bank. Data were analyzed for 46 banks on deposits received from, and commissions paid to, the random sample of broker-dealers during the calendar year 1968. Table XIII–76 shows the distribution across banks of the percentage of broker-dealer depositors that were paid commissions or credited with imputed commissions. Since designated commissions could not be paid at the discretion of the banks, these commissions were excluded from the analysis.[65] Two-thirds of the broker-dealers receiving commissions from a bank maintained deposits at that bank. Seven of the 46 banks had deposit relationships with 90 percent or more of their commission recipients.

---

[63] Mutual Fund Report, at 16, 17.

[64] *Id.*, at 17.

[65] Free commissions of less than $500 were excluded. In a large number of instances firms received free commissions of small amounts, often under $100. It is possible that orders of customers not designating a broker have been combined with orders from customers designating a broker-dealer. Thus, a small amount of free commissions would also go to the designated brokers.

Non-depositors on average received a much smaller portion of the free commissions paid than did depositors. This is shown in Table XIII–77. Although only two-thirds of the broker-dealers receiving commissions were depositors, the commissions paid to depositors by these banks accounted for 87 percent of their free commissions. In seven of the banks at least 97.5 percent of actual and imputed free commissions went to depositors. In addition, 11 banks' broker-dealer depositors accounted for between 90 percent and 97.5 percent of commissions paid by those banks.

Table XIII–78 shows the percentage of depositors paid actual, or credited with imputed, free commissions. Three-fourths of all broker-dealer depositor relationships resulted in the receipt by the broker-dealer of commissions from the bank. Eleven banks paid at least 90 percent of their depositors some commissions, eight banks paid 80 to 90 percent of their depositors some commissions, and 10 banks paid 70 to 80 percent of their depositors some commissions.

If the banks were to choose at random one of the broker-dealers in the sample to execute their orders, the chance of choosing one of their depositors would have been only about one in 20. Of course, the choice of a broker-dealer is not random, and subjective considerations unrelated to the existence of any commercial relationships would increase the probability of a bank dealing with one of its depositors. Two factors increasing the likelihood of a bank dealing with a depositor are the size and location of the broker-dealer. The operations of the largest broker-dealers, especially wirehouses, require deposits in numerous banks, thereby increasing the chance that they will have a deposit relationship with a bank that gives them commission business. A local broker-dealer of course also is likely both to have deposits and receive commissions from his local bank.

Extensive interviews conducted by the Study of both broker-dealers and banks indicate that the strong relationship between depositors and commission recipients is not one of chance. In almost every instance the persons responsible for the trading function of a bank trust department are aware of the relationship between various broker-dealers and the commercial part of the bank. In some banks the trader receives a memorandum outlining to some extent the importance of the commercial relationship on a regular basis, in most instances monthly. Some of these memoranda were merely precatory, suggesting broker-dealers to be used; others went so far as to list the dollar amount of commissions to be paid to individual broker-dealers. Another common form was a schedule of the percentage of free commissions to be allocated to each broker-dealer.

The criteria used in determining which broker-dealers are to be compensated for commercial relationships and the extent of the compensation vary from bank to bank. In the late 1960's tight money dictated that deposits play the major role in the allocation. In prior periods, when money was more widely available, loan relationships played a more important part. At most banks that allocate brokerage on a reciprocal basis, no allocation of commissions in the latter half of the decade was made on the basis of outstanding loans to a broker-dealer.

At some banks, commissions are not allocated directly on the basis

of deposits. Instead the commissions independently paid to broker-dealers are used as leverage to seek deposits from the recipient broker-dealers.

Regardless of whether deposits precede or follow the receipt of commission business, it has been common for banks and broker-dealers to attempt to use the deposit-commission relationship to influence one another's behavior. Meetings between bankers and broker-dealers where the broker-dealer is asked to increase its deposits to reflect a high volume of commissions, or where the bank is exhorted to increase its commissions to reflect the high deposits of a broker-dealer appear to have been quite a common form of business negotiation. Broker-dealers have offered to make an initial deposit in a bank in return for commission business.

In a number of banks commissions that were allocated for deposits and other commercial relationships were systematically apportioned among broker-dealers having a relationship with the bank. One banker whose responsibilities included the determination of whether a broker-dealer's deposits and commissions paid by the bank were "in ratio," explained to the Study that at the end of each month he receives a list of each broker-dealer's average deposit balance during the past month from the Wall Street relations part of the commercial department. He is responsible for seeing to it that, by the 15th of the following month, all broker-dealers are in equal ratio. In certain instances large blocks have been offered to the bank by broker-dealers that either do not have deposits or already are in ratio. The commissions generated by the large block would throw the offering broker-dealers out of ratio. Another investment officer from the same bank pointed out that he felt it a difficult decision for himself or any of the other investment officers to accept such an offer since making the transaction would throw the broker-dealers out of ratio. At other banks a specific dollar amount to be paid to each broker is communicated to the investment department by the commercial department.

According to the banks interviewed, commission payments allocated for deposits tend to be between seven and 10 percent of the collected balances of each broker-dealer. Since collected balances are greater than the deposits as recorded on the broker-dealer's books, the gross return to the broker-dealer from its viewpoint probably runs to between 15 and 25 percent of deposits.

When allocating commissions some banks consider whether a deposit account is active or inactive. The lack of paperwork in inactive accounts is a savings to the bank and some banks will compensate them at a higher rate. Any higher rate of payment may be offset to the extent that an inactive account generates no float.

The advantage of having commercial relationships with numerous banks has been one of the factors leading to a proliferation of broker-dealer bank deposits and loans. Table XIII–79 shows the number of banks in which broker-dealers maintain demand deposit accounts. The 181 broker-dealers in the random sample maintained 2,055 depositor relationships, an average of more than 11 per broker-dealer.[66] Of these, 1,075, an average of six per broker-dealer were termed "in-

[66] Multiple accounts at an individual bank have been combined for purpose of this analysis.

active", that is, accounts which had fewer than 10 transactions during the period January 1, 1968 to June 30, 1969.[67] In some instances these inactive accounts exist for reasons unrelated to the generation of commissions. For example, the maintenance of a depositor relationship facilitates borrowing. It is probable, however, that the large number of these deposits indicates that a broker-dealer needs to maintain a commercial relationship in order to increase his commission business.

The 96 broker-dealers in the selected sample of institutional firms had about 8,500 deposit relationships, an average of 88 per firm. Of these accounts, 4,754, or about 50 per firm, were inactive.

Table XIII–79 also shows the loan relationships of the sample of broker-dealers. One hundred of the 181 broker-dealers in the random sample borrowed money from at least one bank, but in only 32 of these cases were there loans from more than one bank. The selected sample, on the other hand, consisting primarily of firms doing a large volume of institutional business, had 1,216 loan relationships, an average of 13 per firm. Of the 87 broker-dealers with bank borrowings, more than one-third borrowed from four or fewer banks. The need for fairly large amounts of credit by some of the institutional firms and wire houses rather than any desire to maintain commercial relationships probably accounts for the large number of borrower relationships. The amount of the loans, however, may in part be indirectly related to the needs of broker-dealers to maintain depositor relationships.[68] One banker told the Study of a broker-dealer who offered to deposit any amount of money in the bank as long as he received a specified return in commission business. The broker-dealer planned on borrowing from another bank the entire amount to be deposited.

In 1968 the 181 broker-dealers in the random sample had more than $20 million in inactive accounts, while the selected sample of 96 broker-dealers maintained about $130 million in such accounts. Because of the float [69] the balances in their active accounts can be measured in different ways: (1) the balance shown on the broker-dealer's books, (2) the balance shown on the bank's books (deposits credited when made, checks debited when honored) or (3) the fully collected balance (deposits credited when collected, checks debited when honored). In response to a request for the average balance on their bank statements during 1968, the random sample of broker-dealers reported active deposits in all banks of about $210 million. The selected sample reported about $825 million in deposits. The percentage of these deposits which represent float is not known. The float in the active accounts may in some instances represent two-thirds or more of the balances as shown on the books of the bank.

The level of sophistication among broker-dealers in their use of reciprocal bank deposits varies greatly. Some firms have employees devoted full time to the management of the broker-dealer's cash. They attempt to maximize the benefits of their deposits by keeping track of

---

[67] Where a broker-dealer had more than one account at a bank the accounts were classified as active or inactive on the basis of the activity in the largest account.

[68] It has been reported that "one well known New York brokerage house borrows money at 9 percent from one bank and deposits it in a famous New York trust institution to get a return of 15 percent in commission business." The American Banker, at 15 (Oct. 9, 1970).

[69] See ch. V.G.3, above.

the commissions generated and, where necessary, will close out an unproductive account. Commonly, broker-dealers will not pay commissions to institutional salesmen on the portion of bank business generated by the deposits. Other firms, under their profit-center accounting system, will charge the value of the cash deposited to generate commission business against the institutional sales department. Many brokerage firms, however, do not maintain close control over their deposit relationships and do not calculate any return on deposits nor withdraw deposits nor shift deposits to other banks to take advantage of changes in returns from reciprocal balances. Some deposits have existed for many years without the current management questioning the policy of keeping them. It was a commonly expressed fear that "pulling an account" from a bank would so alienate the bank that it would no longer do business with that broker-dealer.

Some broker-dealers, believing it to be preferable, spread their active accounts around among several banks. They may do this by having separate accounts at different banks for different departments of their firm. Others alternate activity among various accounts. Thus, in January all activity will be with one bank, in February with a second bank, and so on.

The banks in the Study's sample had broker-dealer demand deposits of more than $1.2 billion. This represented about 2 percent of their total demand deposits.[70]

Most banks have stated that before commissions are allocated to depositors, priority is given to customer designations and research, and that much, and in some instances all, of the remaining commissions are distributed to broker-dealers having commercial relationships with the bank.

Table XIII-80 shows actual commissions less designated and research commissions paid by the bank as a percentage of the average collected balances on broker-dealer deposits. The 32 banks for which data were available paid out commissions equalling 10.4 percent of the amount on deposit. Fifteen of the banks paid out commissions for other than designation and research equal to less than 10 percent of broker-dealers' collected balances, five for less than 5 percent.

In one of the banks studied the desire to allocate commissions to depositors outweighs all alternative uses other than customer designation. At that bank no commission allocations for research were permitted until 1968, at which time $22,000 in research commissions was divided up among 19 broker-dealers. On the basis of this one year of experience the bank decided to abandon any future research payments and to use those commissions to compensate depositors. This same bank stated that it does not use the third market since no third-market firm has any deposits with their bank.

During the past few years the use of systematic reciprocity has been attacked as a violation of the antitrust laws.[71] Many banks, recog-

---

[70] For a further discussion of the importance of these deposits to banks see ch. V.G.3, above.

[71] *See, e.g., United States* v. *Bethlehem Steel Co.,* Civil No. 70–3102. consent judgment, 1970 Trade Cas. ¶ 73,376: *United States* v. *Republic Corp.*, Civil No. C70–609 (N.D. Ohio. filed June 29, 1970), consent judgment, 1970 Trade Cas. ¶ 73,246; *United States* v. *Inland Steel Co.,* Civil No. 70 C1305 (N.D. Ill., filed June 1, 1970), consent judgment. 1970 Trade Cas. ¶ 73,197; *United States* v. *United States Steel Corp.,* Civil No. 69–729 (W.D. Pa., filed June 13, 1969), consent judgment, 1969 Trade Cas. ¶ 72,826.

nizing the potential antitrust liability of their activities, have claimed to be making their brokerage allocations less systematic.[72] Some banks apparently continue to allocate commissions to depositors, but not on a set ratio of commission to deposits. A few banks claim to have abandoned reciprocity to the extent that the traders no longer receive communications on commercial relationships.

In the summer of 1970 the Antitrust Division of the Department of Justice advised the American Bankers Association to inform its membership that any bank allocating brokerage commissions on the basis of broker-dealer deposits is risking an antitrust suit.[73] The three Federal agencies regulating banks have each initiated procedures to examine the methods used by banks to allocate brokerage commissions.

c. *Commission payments to broker-dealers selling mutual fund shares*

Most sales of mutual funds in the United States are made by independent broker-dealers, unaffiliated with the manager or principal underwriter of the mutual fund. For their sales effort these broker-dealers receive the dealer discount portion of the sales load, typically from six to eight percent of the dollar amount of shares sold.[74] In addition, a broker-dealer enhances his chances of receiving mutual fund brokerage commissions by selling mutual fund shares. Although on the average only one of seven of the broker-dealers in the random sample sold shares of a particular complex of funds, these fund sellers represented 56 percent of the broker-dealers receiving at least $500 in commissions from that complex. Table XIII–81 shows the distribution of complexes by the percent of commission recipients who sold shares of that complex. For eight of the 40 complexes, such sellers represented at least 80 percent of the broker-dealers receiving at least $500 in commissions from the complex and for another 12 complexes these fund sellers represented between 60 and 80 percent of the recipients. Although these fund sellers represented 56 percent of the commission recipients they received less than a third of the commissions paid by the complexes.

The large number of fund sellers and their generally small size make it difficult in most instances to reward such sellers with brokerage.[75] In addition, the larger average size trades executed by mutual funds would, in many instances, lead to an execution by block positioning firms or third-market firms, most of which are not fund sellers. Table XIII–82 shows that in 1968 investment company complexes paid brokerage commissions to only 31.5 percent of the broker-dealers selling shares of any fund in the complex.

---

[72] To some extent the trend away from systematic reciprocity may be in part due to quest for "performance" which may have led some banks to rely more on the ability of a broker-dealer to supply research and execution services.

[73] The warning was reiterated in a speech before the Federal Bar Association by Donald I. Baker, Deputy Director of Policy Planning of the Antitrust Division. No such suits have been filed by the Government. In December 1970 private civil complaints were filed against two large New York banks on behalf of their trust beneficiaries alleging that the banks allocated commission business on the basis of broker-dealer deposits. It is alleged that in doing so they violated the Sherman Anti-Trust Act, the Securities Exchange Act of 1934, the National Banking Laws and common law principles.

[74] For a full description of mutual fund distribution see Mutual Fund Report, ch. V.

[75] A study of 2,843 NASD members found that 800 retailed mutual fund shares as their principal activity. Of these 800 firms, 457 had gross income of under $20,000 and another 170 had gross income between $20,000 and $50,000. Only one firm with gross income over $2 million retailed mutual funds as its principal activity. Booz, Allen, *Over-the-Counter Markets Study,* (1966).

Most fund commission dollars, however, were paid to mutual fund sellers. The Study's survey of 40 investment company complexes whose funds were distributed by independent broker-dealers showed that 62 percent of the commissions paid (to the random sample of broker-dealers) was paid to sellers of their funds. As shown in Table XIII–83, nine complexes distributed at least 90 percent of their commission dollars to sellers of their shares. An additional 10 distributed between 70 and 90 percent to fund sellers.

The payment of investment company commissions to sellers of the investment company's shares was discussed in length at the SEC Rate Hearings. At these hearings, testimony was taken about reciprocity from broker-dealers, securities exchanges, and investment company managers. The various reciprocal arrangements were described in detail. One large fund complex described its brokerage allocation as follows:

> We have some internal guidelines by which we try to operate and we divide internally, the producing dealers into three categories.
>
> (1) Those whose sales are, on an annual basis, between a quarter and a half million dollars annually.
>
> (2) Sales dealers whose sales are between a half a million dollars and a million dollars annually.
>
> (3) Those whose sales are in excess of a million dollars.
>
> Now, in these three categories, our internal guidelines are, in the first group, the smallest of the three groups, our objective is one-to-one-and-one-half percent.
>
> The second group, two-to-two-and-a-half percent.
>
> And the group over a million dollars, three-to-three-and-a-half percent.[76]

The reciprocal arrangements of some others were not so complex in that no attempt was made to separate broker-dealers into groups based on sales volume.[77]

The ability to distribute reciprocal commissions is dependent on the exchange memberships held by the broker. Since most investment company portfolio transactions are executed on the NYSE, it is easiest to allocate brokerage to NYSE members. Members of regional exchanges which have dual trading in NYSE listed stocks cannot be allocated brokerage as easily as NYSE members but with less difficulty than non-members of any exchange. Even prior to December 5, 1968, when the exchanges changed their rules on the sharing of commissions, it was easier to compensate fund sellers who were NYSE members than non-members. Since then the difficulty of compensating brokers without a NYSE membership has increased considerably.[78] NYSE members, thus, are at an advantage vis-a-vis non-members and have had to that extent an extra incentive to sell mutual funds. During the decade of the 1960's the percentage of mutual fund sales made by NYSE members increased. Table XIII–84 shows, for the years 1962 through 1969, total mutual fund sales and mutual fund sales by NYSE member firms. In 1962, NYSE members accounted for an estimated 21 percent of total mutual fund sales. During the next two years, their percent of total sales declined to about 20 percent. Starting in 1965, however, fund sales by NYSE members began to rise. By 1968 they represented 39 percent and in 1969, 38 percent of total sales. Since

---

[76] SEC Rate Hearings, at 1981–1982.

[77] *See, e.g.*, SEC Rate Hearings, at 1864, 2096.

[78] See sec. B, above, for a description of how commissions were paid before and after December 5, 1968.

about one-third of total mutual fund sales in 1967 and 1968 were not made by independent broker-dealers [79] but by captive sales forces or the fund management itself, the percentage of sales by NYSE members becomes even more significant.

The brokerage allocation practices of investment companies have been conducted relatively openly. The Commission's disclosure requirements have made it necessary for investment companies to detail the extent of their reciprocal brokerage arrangements in fund prospectuses. One current prospectus had the following disclosures:

> In buying and selling portfolio securities, the Fund always seeks the best price and execution available. Securities listed on an exchange may be bought or sold in "block" transactions off the exchange or in "cross" or regular transactions on the exchange. Transactions in unlisted securities may be effected with dealers who are acting as principal for their own account. On occasion, securities may be purchased directly from an issuing company.
>
> Subject to obtaining the best price and execution available, portfolio transactions involving specified commissions, such as transactions on a stock exchange, are frequently placed for execution with dealers who sell shares of the Fund and of the other funds distributed by [the Fund's underwriter, an affiliate of the Fund's Adviser] or with dealers who furnish statistical, quotation and other information to the Adviser. No regular formula is used in placing such transactions. During its last fiscal year the Fund paid brokerage commissions aggregating $923,896 of which about 49% went to dealers primarily because of their sales of fund shares, and about 51% to other dealers including those who furnished such information to the Adviser.
>
> Dealers who sell fund shares and dealers who furnish information may also participate in portfolio transactions not involving payment of a specified commission, such as many over-the-counter transactions, but generally such transactions are not directed to them on account of such sales or information. The Fund seeks the best price and execution in such transactions.
>
> The Adviser considers the statistical, quotation and other information received from dealers useful, though not essential, in the performance of its obligations under its advisory contracts, and is of the opinion that such information does not necessarily reduce its expenses.

d. *Insurance Companies and broker-dealer reciprocity*

Reciprocity between insurance companies and broker-dealers does appear to exist to some extent. The nature of the past relationship between these two industries, however, has somewhat limited the potential for reciprocal dealings. Prior to recent years the business done by broker-dealers with insurance companies consisted primarily of insurance coverage for the broker-dealer. There are more than two dozen types of general insurance policies which are either necessary or valuable for a securities firm. In addition, there are numerous employee benefit types of insurance purchased by these firms.[80]

---

[79] Based on unpublished data collected by the Investment Company Institute, Washington, D.C.

[80] For a discussion of insurance plans available to securities firms see F. Zarb and G. Kereks, *The Stock Market Handbook*, 867–879 (1970).

In 1969 the insurance costs of NYSE member firms were more than $14 million. The distribution of these insurance premium payments is to some extent made with reciprocity in mind. It is not unusual for a broker-dealer to divide his insurance business between several insurers in the hope that each relationship may result in the receipt of some brokerage business. Other brokers will consider whether or not an insurer is a good brokerage customer before placing a policy with that insurer. This type of reciprocity is casual: it is not as systematic as reciprocal relationships between broker-dealers and banks or investment companies. Although the Study was told by one insurer that his company gives some consideration to insurance relationships when choosing broker-dealers, this practice does not appear to be widespread. In no case is the Study aware of brokerage allocations systematically related on any basis to insurance premiums.[81]

During the last few years there have been two major developments which have a potential for increasing broker-dealer insurance company reciprocity: the acquisition or founding of mutual funds by insurers and the sale of insurance by broker-dealers. The broker-dealer can, as he has in the past for investment adviser managed funds, serve as a seller of these shares.[82] The potential use of insurance company brokerage to aid in the distribution of insurer managed funds could provide a significant incentive to broker-dealers to sell these funds.

Although the federal securities laws do not prohibit broker-dealers from selling insurance, the practice has been limited by stock exchange regulations. In 1969 the Midwest Stock Exchange amended its rules to permit member firms to sell insurance.[83] Few of its member firms have as yet done so.[84]

---

[81] The insurance laws of New York State have anti-inducement provisions which might be violated by any systematic reciprocal arrangements. N.Y. Ins. Laws § 209 (McKinney 1966).

[82] Presently most insurance company managed funds are sold by the insurer's agents or persons affiliated with the insurer rather than independent broker-dealers. *See* ch. VI.C.

[83] Midwest Stock Exchange Rules, art. XXXI.

[84] Dual members of the NYSE and MWSE are still prevented from selling insurance under the rules of the NYSE.

TABLE XIII-76

Percent of Broker Dealers Receiving Actual and Imputed Free Commissions
Who Were Bank Depositors
Banks

Calendar Year 1968

Percent of Broker-Dealers Paid Actual and Imputed Free Commissions Who Were Bank Depositors 1/	Number of Banks
90 and over	7
80 to 90	7
70 to 80	5
60 to 70	11
50 to 60	3
40 to 50	6
30 to 40	5
Under 30	2
TOTAL	46

Average for all banks 67.0 percent

1/ Free commissions include both actual and imputed commissions less any commissions paid at the designation of customers. Free commissions of under $500 were also excluded.

Source: Forms I-7, I-61.

TABLE XIII-77

Percent of Actual and Imputed Free Commissions
Paid to Depositors

Calendar Year 1968

Percent of Actual and Imputed Free Commissions Paid to Depositors 1/	Number of Banks
97.5 and over	7
95 to 97.5	6
90 to 95	5
85 to 90	8
80 to 85	5
70 to 80	2
60 to 70	3
50 to 60	4
Under 50	6
TOTAL	46

Average for all banks 86.9 percent

1/ Free commissions include both actual and imputed commissions less any commissions paid at the designation of customers.

Source: Forms I-7, I-61.

TABLE XIII-78

Percent of Depositors
Receiving Free Commissions
43 Banks

Calendar Year 1968

Percent of Depositors Receiving Commissions 1/	Number of Banks
90 and over	11
80 to 90	8
70 to 80	10
60 to 70	7
50 to 60	5
Under 50	2
TOTAL	43

Average for all banks 74.2 percent

1/ Free commissions include actual and imputed Commission less any Commission paid at the designation of customers. Free commissions of under $500 were excluded.

Source: Forms I-7, I-61.

TABLE XIII-79

Number of Banks Where Individual Broker-Dealers Had Demand Deposit Accounts or Loans Outstanding
January 1, 1968 - June 30, 1969

Number of Banks Where Broker-Dealers Had Accounts	Demand Deposit Accounts				Loans	
	Active[1/]		Inactive			
	Random Sample	Selected Sample	Random Sample	Selected Sample	Random Sample	Selected Sample
0	3	2	89	9	81	9
1 - 2	104	7	41	4	68	16
3 - 4	26	5	9	6	6	16
5 - 6	17	9	6	5	8	7
7 - 8	11	7	11	6	7	7
9 - 10	4	7	5	4	5	5
11 - 15	6	15	9	13	2	10
16 - 20	4	7	2	5	2	4
21 - 30	3	9	2	9	1	11
31 - 40		5	1	5		7
41 - 50	1	4	1	5	1	2
51 - 75		9	3	9		2
76 - 100		1		2		
101 - 200	2	6	1	11		
over 200		3	1	3		
Total	181	96	181	96	181	96
Total Accounts	980	3741	1075	4754	383	1216

1/ Active accounts had ten or more transactions in the period January 1, 1968 to June 30, 1969.
Source: Form I-61.

TABLE XIII-80

Bank Brokerage Commissions
As a Percent of
Broker-Dealer Bank Deposits

Calendar Year 1968

Actual Commissions Less Designated and Research Commission As a Percent of Broker-Dealer Bank Deposits 1/	Number of Banks
Under 5	5
5-10	10
10-15	2
15-20	5
20-25	5
25 and over	5
TOTAL	32

Average for all banks	10.4

1/ Bank deposits are average collected balances.

Source: Forms I-7, I-60.

TABLE XIII-81

Percent of Commission Recipients that Sold Shares of the Funds from which the Commissions Were Received

Calendar Year 1968

Percent of Commission Recipients Who Were Also Fund Sellers 1/	Number of Investment Company Complexes
90 and over	4
80	4
70	5
60	7
50	6
40	2
30	3
20	5
10	1
Under 10	3
TOTAL	40

Average for all funds - 55.6 percent

1/ Includes only those broker-dealers receiving commissions of at least $500.

Source: Forms I-7, I-61.

TABLE XIII-82

Percent of Fund Sellers Paid Commissions
by the Investment Companies
Whose Shares They Sold

Calendar Year 1968

Percent of Fund Sellers Paid Commissions	Number of Investment Company Complexes
80 and over	1
70 to 80	1
60 to 70	1
50 to 60	6
40 to 50	6
30 to 40	11
20 to 30	8
10 to 20	2
Under 10	4
TOTAL	40

Average for investment company complexes - 31.5 percent

Source: Forms I-7, I-61.

53-940 O - 71 - pt. 4 - 58

TABLE XIII-83

Percent of Actual and Imputed Investment Company Commissions
Paid to Sellers of Fund Shares
Calendar Year 1968

Percent of Actual and Imputed Commissions Paid to Fund Sellers	Number of Investment Company Complexes
90 and over	9
80	4
70	6
60	4
50	2
40	3
30	3
20	0
10	4
under 10	5
TOTAL	40

Average for 40 investment company complexes 62.3 percent.

Source: Forms I-7, I-61.

TABLE XIII-84

Mutual Fund Sales
NYSE Members and Total Fund Sales

1962 - 1969

Year	Mutual Fund Sales ($millions)		NYSE Members' Sales as a Percent of Total Fund Sales
	NYSE Member Firms 1/	Total 2/	
1962	522	2,444	21.3
1963	432	2,135	20.2
1964	597	2,940	20.3
1965	1,036	3,786	27.4
1966	1,299	4,183	31.1
1967	1,473	4,124	35.7
1968	2,421	6,187	39.1
1969	2,305	6,030	38.2

1/ As estimated from Income and Expense Reports filed by NYSE member firms.

2/ Investment Company Institute data.

D. AFFILIATIONS BETWEEN INSTITUTIOAL INVESTORS AND BROKER-DEALERS

1. Types of Affiliations Between Institutional Investors and Broker-Dealers

A number of institutional investors, especially investment advisers and insurance companies, are affiliated by ownership with one or more broker-dealers.[85] Most of these affiliations are on the distribution or sales side of the institutional investors, for example, between the adviser to a mutual fund and the fund's principal underwriter that distributes fund shares for sale to the public. Other affiliations are on the portfolio or investing side of the institutional investors, for example, between the investment adviser to a mutual fund and a broker-dealer that handles all or part of the execution, clearance and confirmation of brokerage transactions for the portfolio of the fund and/or the accounts of others. The sales type of affiliation and the brokerage type are separate: some institutional investors have one but not the other, some have both and some have variations of them. While all such affiliations can be viewed as responses, among financial institutions and among broker-dealers to the competition for investment funds, specific reasons for affiliation have been:

(*a*) reducing the cost of brokerage commissions to the accounts managed by the institutional investor, often while increasing the income of the institutional investor, itself;

(*b*) diversifying the business of the institutional investor in the financial area while supplying additional sources of capital to the broker-dealer; and

(*c*) using the distribution facilities of an affiliated broker-dealer to sell the services provided by the institutional investor.

a. *Reducing the cost of brokerage commissions to the accounts managed by the institutional investor, often while increasing the income of the institutional investor, itself*

(1) *Investment adviser affiliates established by broken-dealers.*—Many broker-dealers are also investment advisers or have established subsidiaries to manage investment companies and other types of accounts. These accounts are normally charged advisory fees separate from the commissions charged on the execution of orders for the account.[86] Because stock exchange minimum commissions have been deemed by the exchanges to include compensation for investment advice these fees are often reduced by all or part of these commissions. The NYSE provides that advisory services "may be furnished by the member or member organization . . . to a non-member, either free of cost or on a fee basis. If such services are furnished on a fee basis, the

[85] For purposes of this discussion an institutional investor is any organization managing money for others either as an external manager, e.g., advisers to most mutual funds, or as an internal manager, e.g., the management of an insurance company.

[86] Sec. 202 of the Investment Advisers Act of 1940 excludes from the definition of investment adviser "any broker or dealer whose performance of (advisory) services is solely coincidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore."

fee may be adjusted in accordance with commission business received . . . from the non-member."[87]

In 1969, 181 of the 379 NYSE member firms filing Income and Expense Reports received some income from fees for account supervision, investment advisory and administrative services. Of these, 49 firms received fees from investment companies and 162 from others. Table XIII–85 shows the distribution among NYSE member firms of the $43.6 million in fees from others. This does not include any fees which were offset by commissions. Eight member firms received $1 million or more in advisory fees; another 12 firms received between $500,000 and $1 million. Of the 181 firms that received some fees, 108 or 60 percent received less than $100,000.

Table XIII–86 shows the growth in importance of advisory fees to NYSE member firms between 1962 and 1969. Between 1962 and 1969 these fees, excluding any fees which were offset by commissions, increased from $11.2 million to $43.6 million, and the fraction of NYSE member firms receiving such fees increased from one-third to almost a half.

The relative importance of advisory fees to NYSE member firms is shown in Table XIII–87. In 1969, 10 percent of the total NYSE member firms had advisory fee income equal to at least 5 percent of their commission income and 2 percent had such income equal to one-fourth or more of their commission income.

One example of a NYSE member firm that advises a substantial amount of assets is Donaldson, Lufkin & Jenrette, Inc. At the end of 1969 it managed $707 million in assets, of which $662 million was for accounts other than registered investment companies. In 1969 these accounts paid advisory fees after brokerage offsets of $620,000, or about one-tenth of one percent of the average assets managed that year. This fee rate is a fraction of the rates generally charged by investment advisers. Of the total $11.7 million in brokerage commissions paid by these accounts, $10.7 million was paid to Donaldson, Lufkin & Jenrette, Inc. These commissions represented 44 percent of the $24.3 million in commissions received by the firm in 1969. To the extent that orders of these accounts led to crosses with non-advisory brokerage customers of the firm, the value of these advisory accounts to the firm was increased.

One NYSE member firm established an organization which is owned by the group of open-end and closed-end investment companies to whom it provides management services. The Union Service Corp. founded by J. & W. Seligman and Co. provides these services to the funds at cost. J. & W. Seligman and Co. profits from this arrangement since it receives most of the commissions paid by the funds managed

---

[87] NYSE Rules ¶ 2440 A. Supp. Material 11. One court has interpreted this more narrowly than the NYSE does. It said, "The only part of the advisory fee that could be credited with brokerage is that miniscule portion of the advisory fee which covered publications such as investment letters, loose-leaf and like investment services, and the conventional statistical information stockbrokers give to customers in return for their business. The anti-rebate rule of the NYSE would not permit a credit against that part of the advisory fee which represented managerial advice beyond what brokers customarily give customers." *Moses* v. *Burgin* CCH Fed. Sec. L. Rep. ¶ 92,747, at 99, 256–60 (D. Mass., 1960). (Appeal pending).

by Union Service Corp. In 1968, the funds in the group had expense ratios (expenses as a percent of average net assets) which were often less than half of those of funds of similar size.[88] Of the total commissions of $3.8 million paid by the Union Service Corp. managed funds in 1968. $3.2 million was paid to J. & W. Seligman and Co.

Other members of the NYSE execute orders for accounts they or their advisory affiliates manage without offsetting any portion of the fee by the brokerage commissions paid by the account. For example, Oppenheimer Management Corporation, a subsidiary of the NYSE member firm Oppenheimer and Company, manages the Oppenheimer Fund, Inc. with net assets of $317 million at year-end 1969. In 1969, $1.7 million of the $3.2 million in total brokerage commissions paid by the fund were paid to Oppenheimer and Company. The management fee is a performance based fee and does not provide for any specified reductions in the fee based on the amount of commission paid to Oppenheimer and Company.

(2) *Broker-dealer affiliates established by investment advisers and other institutional investors.*—In recent years a number of institutional investors have established brokerage affiliates that have joined exchanges and executed orders for the institution and others.

In 1965 Waddell & Reed, Inc. an adviser managing $2 billion in mutual fund asssets, formed a broker-dealer subsidiary, Kansas City Securities Corporation, which joined the Pacific Coast Stock Exchange (PCSE). Within the next year Kansas City was joined on that exchange by subsidiaries of three other mutual fund advisers.[89] In each instance these advisers reduced the management fees of the funds under their management by part or all of the net profits earned by the member subsidiaries. Since then other investment advisers have formed broker-dealer affiliates which have joined regional exchanges, especially the PCSE and Philadelphia-Baltimore-Washington Stock Exchanges (PBW).

In addition to investment advisers, some insurance companies have established broker-dealer subsidiaries to execute orders for the insurance company and other accounts. These include the Insurance Company of North America, Connecticut General Insurance Corp. and CNA Financial Corp.

Some investment advisers which have established subsidiaries to join an exchange have done so to increase their income from the accounts they manage. Waddell & Reed, for instance, while crediting part of the profits of Kansas City Securities Corp. against the funds' management fees, retains a portion of the profit for itself.

Even if a fund adviser offsets the management fee by the total net income earned by an affiliated broker on the funds' transaction, it may still receive financial benefits from the arrangements. For instance, one such arrangement provides for the deduction of an allow-

---

[88] For instance, Broad Street Investing Corp., in the last ten years has had annual expense ratios ranging from 0.18 percent to 0.26 percent while most comparable size funds had expense ratios in excess of 0.50 percent.

[89] The firms are: IDS Securities Corp. a subsidiary of Investors Diversified Services, Inc., Emmet A. Larkin Co., Inc., a subsidiary of Channing Company, Inc., and Imperial Securities, Inc., a subsidiary of Imperial Financial Services, Inc.

ance for income taxes of the brokerage affiliate in determining the brokerage affiliate's net income.[90] Since the adviser and the brokerage affiliate file a consolidated tax return the after-tax income of the adviser is increased.[91]

b. *Diversifying the business of the institutional investor in the financial area while supplying additional sources of capital to the broker-dealer*

Some affiliations between broker-dealers and institutional investors were motivated as investments for the parent rather than as a means of combining in one enterprise the brokerage and management of accounts. In 1969 two major broker-dealers, Blyth and Co., Inc. and Jefferies and Co., Inc. were acquired, respectively, by the Insurance Company of North America and Investors Diversified Service, Inc.[92] (both of which had already established brokerage subsidiaries which became members of regional exchanges to execute orders for their own accounts). Prior to their acquisition both firms were members of the NYSE. Upon being acquired both firms left the Exchange since they would have been in violation of the Exchange rules then in effect prohibiting public (and institutional) ownership of member firms. Prior to this two members of the Midwest Stock Exchange (MWSE), Equitable Securities Corp. and Halsey, Stuart and Co., Inc., were acquired, respectively, by the American Express Co. and the Chicago Title and Trust Co.

In each of the four cases the acquisition was made as an investment with the acquired broker-dealer continuing to do a general broker-dealer business with customers other than the acquiring institutional investors or the accounts managed by those institutions. In the case of the two MWSE member firms, the parents agreed that the broker-dealer subsidiaries would not execute orders of accounts managed by

---

[90] For example, see the prospectus of the Dreyfus Fund, Inc.

[91] For example, a mutual fund manager with a scheduled fee of $2 million and a brokerage subsidiary with pre-tax income of $1 million would offset the management fee by $500,000 (assuming a 50 percent tax rate). On consolidated pre-tax income of $2.5 million ($1.5 million management fee and $1 million in brokerage net income) the adviser would net $1.25 million after taxes. Without the subsidiary the adviser would have received a $2 million fee on which it would have netted only $1 million after taxes.

[92] In September 1969 Investors Diversified Services, Inc., also acquired John Nuveen and Co., the investment banking subsidiary of Nuveen Corporation which had been a member of the NYSE until July 1969. It left the NYSE after a loan from the Paul Revere Life Insurance Co. placed it in violation of the Exchange's restrictions on public ownership.

the parent, nor would the broker-dealer subsidiaries share directly or indirectly in the brokerage commissions paid by the accounts.[93]

One member firm of the NYSE, F. Eberstadt & Company has a subsidiary which manages the Chemical Fund, Inc. Unlike most broker-dealer affiliated funds, the Chemical Fund, Inc. has not purchased or sold any securities through F. Eberstadt and Company nor has it indirectly paid Eberstadt any brokerage commissions. Eberstadt's interest in the fund's management company has been that of an investor.

c. *Using the distribution facilities of an affiliated broker-dealer to sell the services provided by the institutional investor*

A third reason for institutional affiliation with a broker-dealer is the desire to be affiliated with an organized distribution system. A large percentage of mutual fund sales historically have been made by "captive" sales organizations rather than independent broker-dealers.[94] The major captive sales organizations that primarily sell mutual funds were established many years ago. During the past few years mutual funds seeking a regular source of sales have been affiliating with insurance companies which have their own large sales organizations. In one recent instance one large fund adviser sought to affiliate with a NYSE member firm with many branch offices. The availability of a large fund sales force was one of the factors in the attempted takeover of Goodbody & Company by Shareholders Capital, Inc. Shareholders Capital, Inc., through a subsidiary. Shareholders Management Company, is the adviser and principal underwriter of Enterprise Fund and other broker-dealer distributed mutual funds. In the mid-1960's Enterprise Fund appeared at or near the top on the mutual fund performance lists, making its shares relatively easy to sell. Between January 1, 1965 and December 31, 1968 the assets of the Enterprise Fund increased from $6 million to $956 million. A turnaround in their performance, combined with a suspension of sales, saw the fund's assets decline to $406 million by June 30, 1970. The acquisition of Goodbody & Company by the Shareholders Capital, Inc., would have given them a sales organization of over 100 offices with more than 1,500 salesmen through whom shares of the Fund could have been actively sold.

---

[93] Under the public ownership rules of the MWSE adopted in 1970, these two firms can now execute the orders of their parents without violating any rules of the Exchange. See sec. 3.d., below.

[94] See sec. 7.c., *above*.

TABLE XIII - 85

Fees for Account Supervision, Investment Advisory and Administrative Services
New York Stock Exchange Member Firms
1969

Account Supervision and Advisory Fees 1/ ($ thousands)	Number of Firms Receiving Fees		
	From Investment Companies	From Others	From All Customers
0	330	217	198
under 100	33	99	108
100- 200	6	22	22
200- 300	4	10	12
300- 400	1	9	11
400- 500		6	8
500-1,000	2	10	12
1,000 and over	3	6	8
TOTAL	379	379	379
Total Fees ($ millions)	8.1	35.5	43.6

1/ Does not include that portion of fees offset by commissions.

Source: NYSE Member Firm Income & Expense Reports: 1969.

TABLE XIII - 86

Fees for Account Supervision and Investment Advice
New York Stock Exchange Member Firms
1962-1969

Account Supervision and Advisory Fees 1/ ($000)	Percent of New York Stock Exchange Member Firms				
	1962	1964	1966	1968	1969
0	67.1	66.1	62.3	59.1	52.2
under 100	26.9	24.2	26.1	25.9	28.5
100- 200	2.3	3.9	4.9	7.0	5.8
200- 300	1.2	2.9	2.7	2.1	3.2
300- 400	1.2	1.3	1.9	0.8	2.9
400- 500	0.6	0.6	1.1	1.8	2.1
500-1,000	0.6	0.6	0.5	1.8	3.2
1,000 and over	0.3	0.3	0.5	1.6	2.1
TOTAL	100.0	100.0	100.0	100.0	100.0
Amount of Fees ($ millions)	11.2	12.4	18.8	28.7	43.6

1/ Does not include that portion of fees offset by commissions.

Source: NYSE Member Firm Income & Expense Reports: various years

TABLE XIII - 87

Fees for Account Supervision and Investment Advice
Relative to Security Commission Income
New York Stock Exchange Member Firms
1962-1969

Account Supervision and Advisory Fees as a Percent of Commission Income 1/	Percent of New York Stock Exchange Member Firms				
	1962	1964	1966	1968	1969
0	67.1	66.1	62.3	59.1	52.2
under 5.0	24.9	27.4	29.1	33.4	37.7
5.0- 9.9	3.8	2.6	5.1	4.4	4.7
10.0-14.9	2.0	2.3	1.2	1.8	1.3
15.0-19.9	0	1.0		0.8	1.6
20.0-24.9	0.9		1.3	0.3	0.3
25.0 and over	1.2	0.6	1.2	0.3	2.1
TOTAL	100.0	100.0	100.0	100.0	100.0

1/ Does not include that portion of fees offset by commissions.

Source: NYSE Member Firm Income & Expense Reports: various years.

2. The Legal Environment

The federal securities laws do not prevent institutional investors from acting as broker-dealers so long as they register with the Commission.[95] Nor do these laws prevent them from being members of a securities exchange. Indeed, two legal issues that arise under the securities laws are: (1) Whether a mutual fund (or other institutional) manager has a legal obligation to seek membership on a stock exchange, and (2) the extent to which any such membership must be used to recapture brokerage commissions for the benefit of the mutual fund (or other account) instead of generating profits for the manager.

With respect to the first issue, the Commission has recently stated in a court brief:

> We are in no way contending that a fund manager has an obligation to join a regional stock exchange or to utilize any specific market in handling any or all portfolio transactions on behalf of its fund. That is a matter of business judgment, to be exercised with a view to the overall best interests of the fund.[96]

This view was later repeated in a published letter of the Commission's general counsel.[97] One court has adopted the Commission's position.[98]

With respect to the second issue, the Commission stated in the same brief that ". . . we wish to make clear that we do not contend that an affiliated broker may not under any circumstances make or retain profits on portfolio transactions that it effects for the fund . . ."[99] Several courts have questioned whether there is an obligation to pass back any of the brokerage commissions generated by the mutual fund's portfolio transactions.[100] No court, however, has questioned the Commission's position that the affiliated broker may not retain any of the brokerage commissions unless it performs some service or confers some benefit to which the fund is not already entitled.[101]

Although it has been widely assumed that the federal banking laws exclude banks from stock exchange membership, that assumption is questionable. The pertinent provisions are Sections 16 and 21 of the Glass-Steagall Act.[102] Section 16, which applies to national banks and members of the Federal Reserve System, limits a bank's "dealing" in stock "to purchasing and selling . . . without recourse, solely upon the order, and for the account of, customers, and in no case for its own account." Section 21, which applies to all recipients of deposits, prohibits banks from engaging "in the business of issuing, underwriting, selling or distributing" stocks.

Section 16 expressly contemplates that banks may execute some transactions as agents. There is nothing in its language to indicate that they may not do so as members of a stock exchange. Language identical to that of Section 21 has been interpreted by the Federal Reserve

---

[95] Banks are specifically excluded from the definition of brokers and dealers. See Securities Exchange Act of 1934, secs. 3(a)(4) and 3 (a)(5).

[96] Memorandum of the Securities and Exchange Commission, objecting to the proposed settlement, p. 13, in Kurach v. Weissman, 49 F.R.D. 304 (S.A. N.Y., 1970).

[97] Securities Exchange Act Release No. 8746 (Nov. 10, 1969).

[98] *Moses* v. *Burgin, supra,* note 87.

[99] *Id.,* at 12.

[100] *Moses* v. *Burgin, supra,* note 87 ; Horenstein v. Waddel & Reed. CCH Fed. Sec. L. Rep. ¶ 92–678, at 98,976 (SDNY., 1970) ; Kurach v. Weissman, *supra,* note 96, at 307.

[101] See, e.g., *Provident Management Corp.,* Securities Act Release No. 5115 (Dec. 1, 1970) ; *Consumer-Investor Planning Corp.,* Securities Exchange Act Release No. 8542 (Feb. 20, 1969).

[102] 12 U.S.C. §§ 24 and 378 ; see also 12 U.S.C. § 335.

Board as inapplicable to transactions "as broker or agent."[103] One private bank, which is subject to Section 21 but not Section 16, has been a member of the NYSE and other exchanges since before the passage of the Glass-Steagall Act.[104] In any event, the staff of the Federal Reserve Board has informed the Study that in the staff's opinion these provisions do not preclude banks from stock exchange membership.

Although Sections 16 and 21 do not appear to prohibit bank membership, their provisions may limit the use to which such membership is put. For example, the requirement that transactions be "upon the order" of customers may prohibit a bank from acting as a broker for an account over which it has sole investment discretion, unless it nevertheless obtains an order from the customer. The requirement that the transaction be "without recourse" may effectively preclude the bank from acting as the clearing broker. Although prior interpretations of the Comptroller of the Currency would have limited the bank to acting as "an accommodation agent for the convenience of customers,"[105] the staff of the Comptroller's office advised the Study that these interpretations do not reflect the Comptroller's current views.[106]

3. Stock Exchange Requirements

a. *The New York Stock Exchange*

Although membership on national securities exchanges of institutional investors or their subsidiaries is not prohibited by statute the pertinent rules of the major stock exchanges have generally been very restrictive. Prior to early in 1970, many stock exchanges including the NYSE did not permit membership by any publicly held organization. The Constitution of the NYSE provided that:

> every holder of voting stock in [a NYSE member] corporation is a member or allied member of the Exchange and is an officer or employee of such corporation who (unless he is in active government service or his health does not permit) actively engages in its business and devotes the major portion of his time thereto, except that such voting stock may be held by the estate of a deceased member or deceased allied member for such period as the Exchange may permit, and every holder of any other class of stock in such corporation is approved by the Board of Governors or is the estate of a deceased holder who has been so approved.[107]

Since every holder of voting stock had to be a member or allied member, and members had to devote the major portion of their time to the business, it was impossible for most institutional investors to be a NYSE member firm or to own any portion of a NYSE member firm.[108]

---

[103] See ch. V.D.7.d above.
[104] Another member firm of the NYSE was a private bank until recently.
[105] Opinions of the Comptroller restricted the bank's brokerage activities to banking customers and precluded it from soliciting them or making a profit on the transactions.
[106] See ch. V.D. 7.d. above.
[107] NYSE Constitution, art. IX, sec. 7(b)2 (August 1969 edition; modified in March 1970).
[108] One notable exception is a large private, i.e., unincorporated bank, Brown Brothers & Harriman and Co. Its predecessor has been a member of the NYSE since 19th century. Unlike incorporated banks Brown Brothers & Harriman was eligible for membership even prior to the change in Exchange rules which permitted corporations to be member organizations. In 1960 the NYSE revised its rule 318 by adding:

"Every member organization shall engage primarily in the transaction of business as broker or dealer in securities or commodities. With the prior approval of the Exchange, member organizations may engage in kindred activities."

Exchange approval was not required for continuing business activities begun prior to the amendment of the rule.

In September 1969 the NYSE proposed to amend its Constitution to permit the public ownership of a member firm. The Exchange's proposal carried twenty conditions three of which bore directly on the question of institutional membership. These were:

(1) That no more than 49% of a member corporation's outstanding voting stock might be held by the public;[109]

(2) That no member might be permitted to have as a customer any non-member who acquired a 5% or more participation in profits of a member firm after the effective date of the amendment;

(3) That "the primary purpose" of a member corporation and its parent, if any, "be the transaction of business as a broker or dealer in securities."

In response to a Commission request for comments on the NYSE proposals some stated that the rules were designed more with the intention of preventing institutions from membership on the NYSE than exercising adequate regulatory control. In their comments the Department of Justice argued:

> There is a strong inference that these restrictions are primarily designed to exclude institutional investors, such as mutual funds and insurance companies, from membership on the NYSE. The NYSE apparently fears that its existing members will lose profitable business if corporations who are now customers are admitted to membership and thereby become entitled to have their securities transactions conducted at the much lower commission rates applicable to members. Seen in this light, these restrictions would appear to be nothing more than a device to avoid a species of vertical integration, a method of supporting the Exchange's high fixed rates for institutional investors and assuring that the present membership retains its existing level of securities commission income. Although this would tend to support and retain in business some smaller broker-dealers, we question whether such a purpose is necessary to the protection of investors under the Exchange Act. Certainly it is doubtful that it outweighs the rule of the widest possible access to a dominant exchange market announced in the antitrust cases cited previously.[110]

Many of the comments were specifically aimed at "the primary purpose" provision and especially its applicability to a parent of the member organization.[111]

The NYSE's argument in favor of the rule was:

> With public ownership, the possibility will exist that persons or parties who are outside the control of the Exchange may own voting securities of a member corporation and, as a group or individually, may control and dominate the affairs of the member corporation. From a self-regulatory standpoint, this situation cannot be solved by requiring the member organization to disclose the

---

[109] The Board of Governors was to be granted discretion to exempt from this requirement non-member corporations which had 49% or more of their stock in public hands prior to January 1, 1969 and had been a bona fide broker or dealer in securities for five years preceding January 1, 1969.

[110] Comments of U.S. Department of Justice on NYSE Proposal to Permit Public Ownership of Member Corporations in response to Securities Exchange Act Release No. 8717 (Justice Public Ownership Letter).

[111] "The term 'parent' means any party who has the power to exercise controlling influence over the management or policies of a member corporation, unless such power is solely the result of an official position with such member corporation. Any party who owns beneficially, either directly or indirectly, more than 25 percent of the voting securities of a member corporation, or more than 25 percent of the outstanding voting securities of any other corporation which directly or through one or more subsidiaries owns beneficially more than 25 percent of the outstanding voting securities of the member corporation, shall be presumed to be the member corporation's parent. Any party who does not so own more than 25 percent of the voting securities of a member corporation shall be presumed not to be such corporation's parent. Any such presumption may be rebutted by evidence but shall continue until a determination to the contrary has been made by the Board of Governors." NYSE, rule 318, supp. material 12.

existence of the parent. Situations may arise where the parent is not required to be a member, allied member, stockholder associate or approved person as those terms will be defined in the Exchange Constitution. To meet this situation, proposed new Section 7(b)(5) would require that any parent be primarily engaged in the business of a broker or dealer in securities. This means that the parent would be required to be regulated by the Commission as a registered broker-dealer or by a state securities commission. To preclude a parent from registering under the Securities Exchange Act of 1934 solely to attempt to meet the eligibility requirements of proposed Section 7(b) (5), the parent would have to be primarily engaged in the business of a broker or dealer in securities.[112]

In its comments the Department of Justice questioned the regulatory necessity for such a provision:

In its October 31 letter, the Exchange sought to justify these limitations as necessary to its regulatory control. We fail to understand how limiting the business alternatives of a member corporation, let alone its parent, is necessary to maintain regulatory control. After all, the Exchange has conceded that control over persons in management positions is sufficient to achieve necessary regulation. No other limitation seems necessary to achieve a legitimate goal of the Exchange Act. Moreover, the Exchange does not now prevent member corporations from having *subsidiaries* not engaged as broker-dealers in the securities business. If it were really concerned about a regulatory need to keep brokerage separate from nonbrokerage businesses, NYSE would refuse to permit member firms to own, as well as be owned by, nonbrokerage businesses.[113]

Investors Diversified Services Corp., a broker-dealer with three broker-dealer subsidiaries [114] which would remain ineligible for membership under this provision, questioned the discriminatory nature of it:

We agree that the controlling interests in a member must be subject to appropriate Exchange supervision, regulation and discipline regarding the activities of the member. But such need should not be used as an anti-competitive device by which to exclude otherwise qualified persons from membership. We consider, furthermore, that the Exchange's power to *expel* a member organization from the Exchange community insures, in practical terms, adequate control over the member's activities.[115]

Waddell & Reed, Inc. also questioned the need for the provision and its discriminatory nature:

It is noteworthy that other exchanges which have as member corporations subsidiaries of publicly held companies have experienced no difficulties whatsoever in exercising their supervisory responsibilities over such members and the controlling persons of the parent. Also note that the NYSE has never imposed such a limitation upon limited partners of member firms, who for the most part are primarily in businesses other than the securities business. Yet limited partners are analogous to a parent corporation of a member firm in that the prime function of both is to supply capital and their prime interest is to make money on their investment. We cannot understand the distinction that NYSE seems to be making—namely, that a wealthy oil man or entertainer can buy a seat on the Exchange and hire competent people to run it for him, but companies like IBM or INA or HFC cannot do likewise.[116]

---

[112] NYSE letter of Oct. 31, 1969 from Robert W. Haack, President.
[113] Justice Public Ownership Letter.
[114] The three subsidiaries are: IDS Securities Corp.; Jefferies and Co., Inc.; and John Nuveen and Co.
[115] Investors Diversified Services Corp. letter of November 14, 1969 in response to Securities Exchange Act Release No. 8717.
[116] Waddell & Reed, Inc. letter of December 18, 1969 in response to Securities Exchange Act Release No. 8717.

Of the three proposals only one, "the primary purpose" provision, survived.[117] The Exchange promulgated a rule explaining what a member firm must do to comply with the provision:

For the purposes of this Rule, a member organization or its parent's activities shall be considered to be the "transaction of business as a broker or dealer in securities" when such member organization including its approved corporate affiliates and subsidiaries, or its parent, as the case may be, acts as a floor trader, specialist, so called "two dollar broker", odd lot broker, arbitrager, or holds itself out to, and transacts business generally with the public as a broker or dealer in securities, including servicing customers' accounts and introducing them to another member organization. A member organization's, or its parent's, "primary purpose" shall be presumed to be the transaction of business as a broker or dealer in securities, if its gross income (including, in the case of a member organization, the gross income of its corporate affiliates and subsidiaries controlled by the member organization) from activities of the type described in the preceding sentence and from interest charges imposed with respect to debit balances in customers' accounts is at least 50% of its total gross income . . . .[118]

Excluded from broker-dealer revenue is any income from investment advisory and investment company management activities.[119]

b. *Philadelphia-Baltimore Washington Stock Exchange*

The rules of some of the regional stock exchanges have been, and still are much less restrictive than those of the NYSE. The Philadelphia-Baltimore-Washington Stock Exchange (PBW) has been active in recruiting subsidiaries of institutional investors for membership.[120] The exchange now has at least 37 such members.[121]

Under the rules of the PBW a member firm can be an affiliate of an institutional investor since that Exchange has no rules which prohibit members from having publicly owned parents or subsidiaries. Although the Exchange's constitution requires that a corporation member's principal purpose be the transaction of business as a broker or dealer in securities, it is applicable only to the member and not its parent.[122] The rules do prohibit banks, subsidiaries of banks or investment trusts from being member corporations.[123]

c. *The Pacific Coast Stock Exchange*

The Pacific Coast Stock Exchange (PCSE) has also permitted membership to subsidiaries of institutional investors but it has been more restrictive than the PBW. Its rules have been changed fre-

---

[117] The Securities and Exchange Commission did not object, in principle, to the Exchange requiring a member to be primarily engaged in the business of a broker or dealer in securities. Nonetheless, the Commission stated that it intended "to review both the appropriateness of the requirement and the suggested standards for its determination . . . after we have the benefit of the Exchange's Study of institutional membership which we have requested to be completed no later than July 1, 1970." Securities Exchange Act Release No. 8849 (March 26, 1970). The study referred to has not been completed.

[118] NYSE, rule 38.12.

[119] Although the NYSE excludes this income in determining the primary purpose of a firm, Ralph DeNunzio, Chairman of the Joint Securities Industry Task Force and Vice Chairman of the Board of Governors of the NYSE, argued that this income should be *included* as securities business income in determining the firm's assessment for broker-dealer insurance bill. *See* Hearings on H.R. 13308 Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 91st Cong., 2d Sess. 390 (1970).

[120] Like the NYSE the PBW has many broker-dealer members that either themselves, or thru subsidiaries manage mutual fund and other accounts.

[121] These include subsidiaries of Dreyfus, St. Paul Company, Insurance Company of North America, Connecticut General Insurance Corp., CNA Financial Corp., and Standard and Poor's Intercapital Inc.

[122] PBW Costitution, art. XIV, sec. 2.

[123] PBW Constitution, art. XIV, sec. 3. Despite this provision Brown Brothers Harriman & Co., and at least three affiliates or subsidiaries of foreign banks are members. The Boston Stock Exchange has also permitted foreign banks to become members of that Exchange.

quently, often under threat of anti-trust suit, to permit membership to some institutions. Other rule changes have served to bar membership to others. When Kansas City Securities Corporation, the broker-dealer subsidiary of Waddell & Reed, Inc., applied for membership on the PCSE, the Exchange permitted them to join. Simultaneously the Exchange adopted the following rule designed to prevent other institutions from joining:

> Except for existing member firms and any firm approved for membership prior to the adoption of this rule, neither the voting nor non-voting stock of a corporate member firm or of any parent corporation shall be owned by the public. The chief business of a member firm and of any affiliate must be that of a broker-dealer in securities.
>
> The term "affiliate" means any person, firm or corporation directly or indirectly controlling, controlled by or under common control with such member firm. The term 'control' means the power to exercise a controlling influence over the management or policies of a person, firm or corporation.[124]

Shortly after the admission of Kansas City Securities Corporation another adviser to funds sold by a captive sales organization, IDS Securities Corporation, applied for membership. On July 1, 1965, the PCSE rescinded the rule it had passed earlier and replaced it with a rule which in effect prevented subsidiaries of mutual fund advisers from becoming members unless the fund was sold through its own captive sales organization. The rule reads as follows:

> Except for a firm primarily engaged in trading for its own account, or acting as a floor broker, no firm shall be eligible for member firm status unless it is primarily engaged in transacting business directly with the public in the purchase and sale of securities through its own partners, officers or sales representatives. If a firm has a parent which is engaged in the securities business, the principal portion of such parent's securities business shall also be that of transacting business directly with the public in the purchase and sale of securities through its own partners, officers or sales representatives. A preponderance of the business of a member firm shall be for the account of persons other than a parent who is not itself a broker or dealer in securities. The term "parent" means any person, firm or corporation who directly or indirectly controls a firm. Nothing herein contained shall abrogate the right of the Board of Governors to impose additional requirements for member firms pursuant to Section 1(a) of Article IX of the Constitution.[125]

A further modification in the rules of the Exchange was made later that year after Channing Financial Corporation, which had earlier ecquired Emmet A. Larkin and Company, a PCSE member, reached an understanding to be acquired by J. C. Penney Co., Inc. A new rule was promulgated to prevent member firms from being controlled by persons outside the securities business. Although the proposed acquisition was never consummated the rule remained in effect. It was later modified to permit certain acquisitions with the approval of the Board of Governors. The current rule states the requirement of the Exchange Constitution that all voting stockholders of a corporate member firm shall be active in the business and that this rule "shall not be deemed to be met in any case where a voting stockholder or proposed voting stockholder is a corporation, unless the principal business of that corporation and of its parents and subsidiaries and affiliated organizations, taken on a consolidated basis, shall be that of a bona-fide broker-dealer in securities. A parent or subsidiary of affiliated organization

[124] PCSE rule IX. sec. 3(a)H. effective February 18, 1965, rescinded July 1, 1965.
[125] PCSE, rule IX, sec. 3 adopted July 1, 1965.

53-940 O - 71 - pt. 4 - 59

may be excluded from such consolidation upon terms and conditions as the Board of Governors may require. Corporate member firms in good standing as October 1, 1965 are exempted from this rule, except as to subsequent transfers of voting stock to corporations which were not affiliated with such firms prior to such date." [126]

There are now at least 18 subsidiaries of institutional investors which have joined the PCSE under the existing rules. They include subsidiaries of the St. Paul Companies, Inc., General United Group, the Dreyfus Corporation, Insurance and Securities, Inc., and the Insurance Company of North America.

d. *Midwest Stock Exchange*

The rules of the MWSE prior to 1970 were very explicit on barring certain institutions from membership. Its rule read:

> No bank, subsidiary of a bank, trust company, investment trust, investment company or holding company shall be registered as a member corporation.[127]

Early in 1970 the MWSE also adopted rules affecting institutional membership. The rules on public ownership require that their members conduct a "general" securities business. Their rule states:

> (i) a substantial portion of the member organization's business consists of acting as broker in securities admitted to trading on one or more national securities exchanges, and the balance of its securities business consists of other types of activities (including underwriting, distributing, retailing, investment advising and over-the-counter market making) in one or more types of securities (including corporate stocks, bonds, governmental securities and mutual funds) traditionally associated with the broker-dealer or investment banking business and consistent with maintaining a flow of orders to trading on the floor of the Exchange, or
>
> (ii) the principal business of the member organization is or will be the performance of an approved floor function—specialist, floor broker or registered floor trader.[128]

Unlike the NYSE, the MWSE assumes that adequate regulatory control could be exercised without any requirement that a parent of a member be a broker-dealer. Indeed they do require that the parent of a member agree to furnish data on its finance, securities transactions and officers and directors.[129] Members' parents are also forbidden to engage in any aspect of the securities business or any course of conduct in the securities business prohibited to members.[130]

The Exchange does require, however, that the member conduct business primarily with the "public" and not with its affiliates. The rule is met if:

> "at least 50 percent of all brokerage commissions earned by the member organization on the Exchange is from transactions for customers other than affiliates, and at least 50 percent of the member organization's gross income from its entire securities business is derived from business with or for customers other than affiliates."[131]

---

[126] PCSE, rule IX. sec. 5(a). The grandfather clause was inserted to prevent the disqualification from membership of Stone and Webster Securities Corp. and Bishop Securities which were controlled by an engineering firm and a trust company, respectively.

[127] MWSE Rules. art. XV, rule 7. This section was modified in 1970.

[128] MWSE Constitution. art. I, rule 1(c)(1).

[129] MWSE Rules, art. XV, rule 8.

[130] MWSE Rules, art. XV, rule 9.

[131] MWSE Constitution, art. I, rule 1(c)(2).

In effect these rules would allow a firm doing a general and public business such as Jefferies and Co. (if it was willing to abide by all other Exchange rules) to be a member firm while denying membership to IDS Securities Corp.

E. SUMMARY AND CONCLUSIONS

1. Long-term Impact of Institutional Investors on the Securities Industry

a. *Overall trends in the securities industry*

The decade of the 1960's was marked by tremendous growth in the volume of securities transactions. In 1968 the dollar volume of trading on all registered exchanges was more than three times greater than in 1960. Between 1962 and 1968 the gross income of NYSE member firms increased from $1.5 billion to $5.4 billion. In 1968 almost every member firm had gross income of more than $1 million; in 1962 only two-thirds of the firms earned that much. In the same period the number of NYSE members with gross income of $50 million and over increased from 1 to 6 percent.

The major source of NYSE member firms' income during the period was the brokerage commissions received on agency orders. Between 1962 and 1968 these commissions increased from $0.9 billion to $3.2 billion. In 1962 only 45 percent of the member firms had $1 million and over in commission income but by 1968 this figure had increased to 83 percent, while the number of firms with commission income of $25 million or more increased from less than 1 percent to 7.57 percent.

After six continuous years of rising volume, 1969 saw the beginning of a decline which has persisted into mid-1970. Share volume on all exchanges declined 7 percent from 1968 to 1969, and the dollar volume of shares traded on all exchanges declined 11 percent.

Commission income on NYSE transactions declined 23 percent, commission income on other exchange transactions 20 percent and on over-the-counter market transactions 13 percent. This was due in part to the decline in dollar volume and prices and in part to the volume discount. Other phases of the broker-dealer business also declined; for example, dividends and interest received declined 36 percent, profit from trading and arbitrage 31 percent, and income from the sale of mutual funds 12 percent.

b. *Growth in institutional investors payments to the securities industry*

Most of the growth in the securities industry during the period 1960–1969 was due to increase in securities transactions by institutional investors. Their share volume increased on the NYSE by 548 percent, compared with a 133 percent increase in individual investor volume. Institutional share volume rose from about a quarter of total 1960 NYSE public volume (excluding members' trading for their own accounts) to about a half of 1969 public volume. Banks and mutual funds alone increased their combined percentage share of NYSE public volume from 18 percent to 34 percent during this period. 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.

In part reflecting the growth in the size of institutions and in part reflecting changing trading policies, the average size of institutional orders executed on the NYSE during this period also increased greatly. The average size of mutual fund orders, for instance, increased from 550 shares to 3,726 shares.

c. *Impact of increased institutional investor business on securities industry profitability*

The growth in institutional trading had a significant effect on NYSE member firm profitability. The business of the primarily retail firms (average commission income per transaction under $50) proved far less profitable during this period than the business of the primarily institutional firms (average commission income per transaction of $100 and over). The 1968 median pretax profits of member firms illustrates this point. The median pretax profit was $824,000 for all NYSE firms, $672,000 for the primarily retail firms and $2.4 million for the primarily institutional firms. While institutional firms represented only 13 percent of the firms, they accounted for 52 percent of the firms earning $5 million and over. The 62 percent of the firms that were retail accounted for only 41 percent of the firms with pretax income of $5 million and over. Fewer than one out of every ten institutional firms, but seven out of every ten retail firms, had pretax profits under $1 million.

These disparities in total 1968 pretax profits were due almost entirely to differences in the profitability of the security commission business. Although the primarily retail firms as a group received two-thirds of all gross security commission income, they accounted for only one-third of the pretax profits on this business. In contrast, institutional firms as a group received only 14 percent of all security commission income but accounted for 39 percent of the pretax profits of all firms. Median pretax profit margins on the security commission business itself were almost 5 percent for retail firms and 27 percent for institutional firms.

These higher 1968 profit margins for institutional firms on their security commission business occurred despite their sharing of commissions with retail firms. In large part this reflected the commission rate schedule in effect in 1968. This schedule did not recognize economies of scale in effectuating a single large order or numerous small orders for the same customer. According to a study done for the NYSE, the average cost of handling a 1,000, a 10,000 and a 100,000 share order of a $40 stock was, respectively, 6, 42 and 377 times the average cost of a 100 share order, yet the commission charges in 1968 was, 10, 1000, and 1,000 times the 100 share commission.

Trading and arbitrage, underwriting and margin interest income accounted for most of the noncommission income of member firms. The institutional firms were much more dependent on commission income as a percentage of their total income than were retail firms. Retail firms, on the other hand, derived more than 10 percent of their other income from distributing mutual fund shares and 30 percent from margin interest income (institutional firms received only minimal percentages of income from these sources). The highly profitable

commission business done by institutional firms may to some extent, however, have been offset by losses suffered on other business. Nineteen percent of the institutional firms lost money on their other business compared with 4 percent of the retail firms. Institutional firms may be willing, for example, to accept the risk of losses on block positioning in order to attract profitable institutional commission business.

d. *Distribution of increased institutional investor business*

Recognizing the profitability of institutional commission business retail firms competed for institutional customers. For most firms income per transaction increased between 1962 and 1968, with 11 firms moving to a higher category of income per transaction for every one firm moving to a lower category.

Institutions allocated the bulk of their commission business by placing agency orders with the broker-dealers of their choice. Prior to December 5, 1968, however, a further distribution of commissions was often made by directing the confirming broker-dealer to pay a portion of the full commission received (that is, to "give-up" a portion of the commission) to other broker-dealers. Between 1964 and 1968 the use of the customer-directed give-up by investment companies increased more than 700 percent. In 1968 all but nine of the 57 investment company complexes studied used the customer-directed give-up. This device was used much less frequently by other institutional investors. A willingness on the part of NYSE members to give-up to other members as much as 70 percent of the commission on a single transaction was fairly common. Some brokers, in fact, were willing to give-up 90 percent on trades that they executed but did not clear or confirm.

In 1968 three out of every five NYSE member firms received some compensation from investment companies in the form of give-ups. Investment company advisers, however, wished to route some of the give-ups to non-members of the NYSE, principally because a significant amount of fund sales were originated by nonmembers of that exchange. Since the rules of the NYSE did not prohibit member firms from executing orders on the regional exchanges, and since some regional exchanges not only permitted give-ups to their own members but permitted give-up distribution to members of the NASD (which has about 3,700 broker-dealer members) or foreign broker-dealers, institutional investors were able to expand their commission dollar distribution by directing broker-dealers to execute orders on those regional exchanges. Brokers worked out complex methods which allowed the institutional investor to direct give-ups to nonmembers of the NYSE even when the order was executed there. Most give-up arrangments had one common characteristic: They permitted the institution to utilize a limited number of executing broker-dealers (lead brokers) that would give-up a large portion of the commission to other broker-dealers. Thus, the number of net recipients of give-ups was about three times greater than the number of net payers.

e. *1968 commission rate changes*

On December 5, 1968, the NYSE adopted an interim commission rate structure which incorporated a volume discount and prohibited customer directed give-ups. The Amex and regional exchanges concurrently adopted similar provisions. The volume discount reduced

commissions on all orders in excess of 1,000 shares on securities selling for less than $90 per share. In no case was the fixed minimum commission on a single order to exceed $100,000.

f. *Impact of 1969 commission rate charges*

One of the major effects of the prohibition of customer directed give-ups was to increase the number of broker-dealers confirming institutional transactions. A number of firms that received no actual (as opposed to give-up) commissions in 1968 began to do so in 1969. Those NYSE member firms that were net payers of give-ups in 1968, as a group, received in 1969 a smaller percentage of total actual investment company commissions (67 percent in 1969, 81 percent in 1968).

Although those firms which in 1968 were net give-up payers were affected in 1969 by the volume discount to a much greater extent than those firms which were net give-up recipients in 1968, in general the give-up prohibition more than offset the volume discount's impact. The firms which were give-up payers in 1968 received $57.1 million less in actual commissions in 1969, but because of the give-up prohibition they retained all their actual commissions whereas in 1968 they had paid out $58.2 million in give-ups.

g. *Profitability of institutional investor business in 1969–70*

The profitability of NYSE member firms declined greatly in 1969. Thirty-seven percent of NYSE members lost money in 1969, while only about 3 percent had lost money in 1968. The 1969 increase in such costs as interest, clerical and administrative salaries, and office and equipment expenses, contributed to the decline in profitability in all firms.

The most profitable firms in 1969, as in 1968, were institutional firms. The retail firms were hit hardest by the volume decline. Forty-two percent showed losses in 1969 while only 18 percent of the institutional firms showed losses. The median pretax profit during this period for all firms was $128,000, for retail firms, $63,000 and for institutional firms, $722,000. More than one-third of the institutional firms had a 1969 pretax profit margin on commission business in excess of 30 percent, while less than 6 percent of the retail firms had that high a profit margin.

In part the continued differences in profitability between retail and institutional firms reflect a commission rate schedule that, despite the December 5, 1968, changes has not fully adjusted to the costs of doing business. According to a study done for the NYSE, the cost of handling a single small order sometimes exceeded the commission rate. The cost of handling a large order still left room for a substantial profit.

2. Allocation of Commissions and Over-the-Counter Business by Institutional Investors

a. *Commissions paid by institutional investors*

Most commissions paid in 1968 by the institutional investors in the Study's sample were for the execution of stock exchange transactions. A lesser amount was paid for the execution of over-the-counter agency transactions.

Investment companies and bank trust departments were by far the largest source of institutional brokerage commissions. These two categories of institutional investors paid out about seven times more

brokerage commissions than all other institutional investors combined (that is, the noninvestment company accounts of investment and visers, life insurance companies, property and liability insurance companies and self-administered pension funds, educational endowments and foundations). Six banks and seven investment company complexes paid out 38 percent of the total commissions reported by all the institutions studied.

Institutions tend to pay commissions to a large number of broker-dealers. The average bank in the Study's sample (the 50 largest trust departments) for instance, received confirmations from 212 broker-dealers, the average investment company complex (the 57 largest complexes) from 136 broker-dealers. Banks on the average used give-ups in 1968 to compensate an additional six broker-dealers and investment companies an additional 59 broker-dealers. The broker-dealers and investment companies an additional 59 broker-dealers. The broker-dealers receiving the greatest amount of commissions from any category of institutions, on the other hand, received a high percentage of the total commission dollars paid out by that category. Fifty broker-dealers accounted for 59 percent of the commissions paid in 1968 by all of the institutions studied.

Most broker-dealers in the Study's random sample receiving institutional commissions tended to have three common characteristics: an NYSE membership, strong capitalization and high gross income.

Over 98 percent of the NYSE member firms in the sample received some commissions from the Study's sample of institutions. Fifty-nine percent of the NYSE firms (but only 18 percent of the nonmembers of the NYSE) received over 5 percent of their gross income in institutional commissions. Of the firms receiving more than $1 million in institutional commissions, 92 percent were members of the NYSE; the remainder were members of the Midwest or Pacific Coast Stock Exchanges.

Fifty-five percent of the firms with less than $100,000 total capital received no institutional commissions. On the other hand, all the firms with over $5 million total capital received some institutional commissions and 44 percent of these firms received over $1 million in institutional commissions. Fifty-four percent of the broker-dealers with gross income over $5 million received at least $500,000 in institutional commissions.

b. *OTC net trades in stock by institutional investors*

On many occasions an institution will transact at net prices in the over-the-counter market for listed and unlisted securities with a dealer that is purchasing the stock for, or selling the stock from, its own account. The banks and investment companies accounted for most of these transactions, in fact, $10 billion of the $11 billion total for all institutions in the sample. The number of broker-dealers dealing at net prices with institutions is far smaller than the number acting as agents. Only the banks, the investment adviser managed investment company complexes and the other accounts managed by investment advisers averaged such OTC trades with more than 15 broker-dealers. Moreover, the business was even more highly concentrated than the commission business, with 10 broker-dealers handling more than half of the net trades reported by each type of institution. The four

broker-dealers with the largest volume of these trades and two of the remaining six in the top 10 by volume made OTC markets in listed securities. For some of these firms much of their institutional OTC business was in stocks in which they did not make markets. In all, 56 percent of the total OTC net trades in both listed and unlisted stocks was done with firms that made such markets.

Almost three-quarters of the broker-dealers in the Study's random sample with more than $10 million in institutional OTC net trades were members of the NYSE, and, like those firms receiving commission business, tended to be heavily capitalized and to have high gross incomes.

c. *Customers designation of broker-dealers*

The manager of an account does not always trade for the account. When the manager does trade, it is not always granted the authority to choose the broker-dealer. A customer, for example, may want to reward a particular broker-dealer which may have introduced the account to the manager, which may have some affiliation with the customer (a large donor to a college whose endowment fund is the account or an investment banker for a company whose pension fund is the account) or which may have performed some service for the institution (such as pension fund performance evaluation). Where an investment adviser or bank trust department is managing individual accounts, the customer may have a relative or friend through whom he wishes account brokerage handled.

The brokerage for about one-third of the investment adviser-managed accounts and more than two-thirds of the bank-managed accounts was reported to be free of customer designation. Some accounts designate a broker-dealer but allow the bank or adviser discretion to deviate from that choice if circumstances warrant. Other accounts allow discretion as long as certain amounts of unrelated commissions are paid to the designated broker-dealer.

Eleven percent of the broker-dealers receiving bank commissions received only "free commissions" (undesignated) and an additional 23 percent received at least 80 percent of their bank commissions as free commissions. Eighteen percent of the broker-dealers, however, received almost all of their brokerage commissions from banks solely because one or more customers had so designated.

d. *Execution and clearance*

More than one-half of the orders to purchase and sell stocks for bank trust departments and non-bank trusts and estates are for 100 shares or less. The techniques involved in the execution of these smaller orders have remained unchanged for decades. On the other hand, the orders of insurance companies, investment companies and pension funds are frequently of large size. The institutional broker-dealer receives such an order because it has developed the ability to find the other side of the transaction among institutions and other large investors.

When seeking an execution in unlisted stocks more than four-fifths of the institutional investors surveyed by the Study dealt on a principal basis directly with a market maker at least a majority of the time. Institutions gave better price, better market quotes and more depth

as the reasons for going directly to market-makers. In some cases, though, an institution might decide to use a broker to compensate it for unrelated services or because the broker may be more familiar with the various market-makers and therefore be able to obtain a better execution. Self-administered institutions, such as endowments and pension funds, tend to deal through agents more often than institutional managers of other people's money.

Although executions in many listed securities may also be obtained net in the third market, two-fifths of the institutions surveyed did not check third market quotations, and only one-fifth checked third market quotations on a majority of their trades. Most institutions cited either inability of some third market-makers to accept large trades or importance of using the auction market for small trades for their reluctance to check third market quotations. Some institutions expressed a belief that an execution unsubstantiated by a tape print could be susceptible to criticism whereas an execution on a regulated exchange could rarely be questioned. Other institutions expressed a preference for the third market, stating that it may offer a better price (after taking commissions into account), allows direct negotiation of the price, offers a known price at which the trade will be accomplished and offers more rapid stock delivery. Some of these institutions claimed that a large order sent to the third-market will not adversely affect the exchange auction market. Some banks (one bank accounted for more than one-half of the total) have increased their own income by executing agency and custody orders in the third-market at net prices and charging the account the net price plus a full or partial commission.

Only about one-fifth of the institutions surveyed "ordinarily" granted a broker-dealer discretion as to the timing of transactions to effectuate a single investment decision. Thirty percent of the institutions "occasionally" granted such discretion while almost two-fifths "never" granted it.

One-half of the institutions surveyed "always" or "ordinarily" granted discretion to choose the executing market, and an additional quarter "occasionally" granted such discretion. It must be remembered, however, that choice of the broker-dealer may be the choice of the market. For example, when an NYSE member receives an order from an institution the institution may well contemplate an NYSE execution. Similarly, an order given to a third-market firm is expected to be executed off the exchange.

In most instances no price discretion is granted to the broker-dealer. Rather, the institution will either place a price limit on the order or request the broker-dealer to check back with the institution before execution.

Clearance and settlement is the process whereby the purchaser of a security receives the certificates and the seller receives the proceeds of the transaction. Unlike transactions of most individuals, institutional investors usually do not pay for a trade until the certificate is delivered to it or its custodian. It is consequently possible for an institution to retain the cash needed to pay for a security it has agreed to purchase (the purchase of which it immediately reflects in the institutional portfolio) for some period of time until settlement—a period that has

become extended by reason of the fails problem and rejection of partial deliveries. The retained cash can in the meantime be put to double use earning some return. Often it is the custodian of the institution's portfolio (usually a bank) to whom the institution has transmitted funds for the purchase rather than the institution itself that benefits from the arrangement. It is the broker-dealer who bears the cost of this situation since it must carry the securities until payment is received. Various proposals are now pending to facilitate the completion of deliveries of securities to institutional investors.

e. *Institutional investor payments for research*

The magnitude of institutional payments allocated to research is based on two factors, the amount of research needed to supplement that produced by the institution and the alternative uses to which the generated commissions may be put. Insurance companies and other self-administered institutions in the Study's sample presently have few alternative uses of commission dollars and reported often paying all or most of their commissions to firms providing them with research. Banks, on the other hand, reported allocating only 12 percent of their total "free commissions" for research (two banks accounted for more than a fourth of the total commissions paid by banks for this purpose) and investment company complexes reported allocating 23 percent of their commissions for this purpose.

In 1968 investment companies paid research commissions to an average of 88 broker-dealers while banks paid such commissions to an average of 49 broker-dealers. In dollar value, however, research commissions tended to be concentrated among a few broker-dealers. In terms of total broker-dealer gross income, banks and investment company commissions allocated for research are relatively insignificant, comprising about 1.4 percent of the total.

In 1968 NYSE firms had research expenses of $97 million, or 2.2 percent of total expenses. Those NYSE firms dealing primarily with institutional investors incurred greater research expenses, both absolutely and in relation to total expenses, than did firms dealing primarily with the public. While the median research expense per retail firm was $45,000, the median for institutional firms was $129,000.

f. *Other services offered to institutional investors*

In addition to execution and research, broker-dealers offer other brokerage-related services to institutional investors including portfolio valuation, custody of securities, financing of margin accounts and facilities for communication between the institution and the broker-dealer.

Many broker-dealers offer to value institutional investor portfolios as often as twice daily, and some broker-dealers also offer to measure the portfolio performance of the institution. Many broker-dealers offer direct, free wires to institutions that generate a substantial commission volume, enough to justify the cost of the wire. Most institutional investors, however, do not use the custody service of a broker-dealer, preferring instead to use bank custodians. Also, most of them do not trade through a margin account—only about 3 percent of the total trading of institutional investors was margined.

g. Reciprocity

Reciprocity (purchasing products or services from those purchasing your products and services) as a well documented form of business behavior in the securities industry. Also well documented, however, are the economic and legal problems attending reciprocal arrangements. The ability to negotiate terms of reciprocal arrangements for many institutional investors has aspects of negotiating commission rates. However, unlike negotiated rates where negotiation could accrue benefits directly to the account managed, reciprocity often tends to benefit the manager and not the account. Absent a specific credit, the accounts benefit only to the extent that management fees and sales loads may be lower than they would be in the absence of reciprocity. Reciprocal considerations bearing on the allocation of portfolio business create a potential conflict of interest between the manager and its account in choosing a broker-dealer or market to use when executing an order. In the past, pressure for lower or negotiated commission rates has come primarily from those institutional investors who have not been able to receive the benefits of reciprocity and those self-managed institutions for which reciprocity is a cumbersome, circuitous way of recapturing part of the fixed commission. These institutions, including the insurance companies and the advisers to mutual funds sold by captive sales forces, represents a small but nevertheless significant portion of the commissions paid by institutions.

Broker-dealers strongly enhance the probability of receiving portfolio brokerage from a bank by maintaining a deposit at that bank. Eighty-seven percent of banks' free commissions were paid to depositors. Seven of the 46 banks studied paid almost 98 percent of their free commissions to depositors.

Extensive interviews with both broker-dealers and banks indicate that the relationship between depositors and commission recipients is not one of chance. The bank traders, for example, reported receiving periodic memoranda outlining the current commercial relationships with broker-dealers. Some of these memoranda simply suggested broker-dealers to be used. Others were less precatory, listing the dollar amounts of commissions to be paid to individual broker-dealers. Banks and broker-dealers sometimes met to negotiate or renegotiate the flow of deposits or commissions, reflecting the increased or decreased activity of either party.

A random sample of broker-dealers illustrated the extent of these commercial relationships. The broker-dealers in the sample averaged 11 deposit relationships with banks. Six of these accounts were "inactive" accounts having fewer than 10 transactions during a one and one-half year period. Although the maintenance of an "inactive" account may have some business justification, the pervasiveness of the practice suggests that many of the accounts reflect a need to maintain the commercial relationship necessary to the receipt of commission business.

After giving priority to customer designations and research obligations, some banks systematically allocated commissions among broker-dealer depositors. The banks in the sample on the average paid out available commissions (total commissions less designated and research commissions) equal to 10.4 cents for every dollar in deposit accounts. The banks interviewed indicated that the ratio to the broker-dealer

may actually run closer to 15 to 25 percent of the deposit balance because of the float in the active accounts.

Many banks, in the face of a warning by the Antitrust Division of the Department of Justice, as well as suits filed on behalf of individuals, claim to have abandoned or modified their former methods of allocation.

Most mutual fund sales in the United States are made by independent broker-dealers, not affiliated with the manager or principal underwriter of the mutual fund. Independent broker-dealers can enhance their probability of receiving mutual fund brokerage commissions by becoming sellers of the funds' shares. Some of the fund complexes studied chose, almost exclusively, to send portfolio orders to broker-dealers selling the funds' shares.

The mutual fund adviser is limited, however, in the amount of brokerage it can channel to the fund seller. The average size of the fund's portfolio order is relatively large, but (in terms of the number of sellers but not volume of sales) retailers of the funds' shares are usually small nonmember broker-dealers without the capacity to execute and clear such transactions. Thus, although most of the commission dollars generated by mutual funds are paid out to fund sellers, most fund sellers receive no portfolio brokerage from the funds they sell.

Since approximately four-fifths of total investment company transactions are on the NYSE, the NYSE members are in a position to be compensated with direct commission dollars. Transactions in NYSE-listed securities may also be directed to regional exchanges where those securities are dually traded in order to compensate regional exchange members for their selling efforts. It is difficult, however, for the investment company adviser (especially since the "give-up" prohibition of December 5, 1968) to compensate the nonmember of any exchange. The advantage held by NYSE members has increased their incentive to retail fund shares. Between 1962 and 1969 their percentage of total mutual fund sales increased from 21 to 39 percent.

Insurance companies will, in some instances, consider insurance relationships in the choice of a broker-dealer. In no case has the Study discovered brokerage allocations systematically related to insurance premiums. It is not unusual, however, for a broker-dealer to purchase insurance coverage from more than one insurer in the hope of maximizing the receipt of insurance company brokerage business. Two recent developments increase the potential for broker-dealer and insurance company reciprocity: First, insurance companies are selling mutual funds and could utilize independent broker-dealers to distribute the shares. Second, members of at least one exchange, the Midwest Stock Exchange, are now permited to sell insurance.

3. Affiliations Between Institutional Investors and Broker-Dealers

a. *Types of affiliations between institutional investors and broker-dealers*

Institutional investors, especially investment advisers with captive sales organizations and insurance companies, have in recent years affiliated through ownership with broker-dealers that execute and/or

clear securities transactions. Broker-dealer affiliations of institutional investors in he past were mostly between an investment adviser to a mutual fund and the principal underwriter (distributor) of the funds' shares who was required to register as a broker-dealer. The new class of affiliates that execute and clear securities transactions are in some cases structured to do so for only the accounts managed by the institutional investor, in some cases only for others, and in some cases to do both.

b. *The legal environment*

These affiliations are not prohibited by the Federal securities laws and do not appear to be prohibited by the Federal banking laws.

c. *Stock exchanges requirements*

Institutional membership has, however, been severely restricted by the constitutions and rules of the various exchanges. The NYSE, prior to 1970, prohibited public ownership of member firms, thus precluding the largest institutional investors from membership. The rules, however, did permit membership to privately held organizations whose primary purpose was the brokerabe business. Within this framework, in 1969 almost half of the member firms received advisory fees from accounts managed by themselves or their adviser subsidiaries. These fees totaled $44 million after offsetting, in some cases, commissions generated by the advisory account. Since early in 1970 the NYSE has permitted public ownership of its members with certain restrictions. These include a provision that the "primary purpose" of the member firm and any parent must be the brokerage business.[132] Since for the purpose of determining the primary purpose advisory fees are not considered part of the brokerage business, this provision effectively precludes most institutional investors from owning more than 25 percent of the voting stock of any member.

The regional stock exchanges have been more permissive than the NYSE in permitting subsidiaries of institutional investors to join. The Philadelphia-Baltimore-Washington Stock Exchange has no provision prohibiting institutional investors or their subsidiaries from joining and many have joined. Although the Pacific Coast Stock Exchange had no prohibitions until 1965, after one large mutual fund adviser joined, it immediately passed rules against such membership. Since then these rules have frequently been changed, often under threat of antitrust suits, to permit broker-dealer subsidiaries of institutional investors desiring membership to join. The present rules, while restrictive, give to the exchange's board of governors certain exemptive powers which have facilitated membership for subsidiaries of institutional investors. The rules of the Midwest Stock Exchange specifically prohibited most institutional investors from membership, but were revised in 1970 as part of the program to implement public ownership. Unlike the NYSE, whose rules exclude from membership any broker-dealer with a parent not in the securities business, the

---

[132] The Commission did not object to the inclusion of this requirement; however, it did indicate that it intended to review "both the appropriateness of the requirement and the suggested standards for its determination . . . after we have the benefit of the Exchange's study of institutional membership which we have requested to be completed no later than July 1, 1970." Securities Exchange Act Release No. 8849 (Mar. 26, 1970). The study referred to has not been completed.

Midwest permits such members as long as their parents agree to comply with certain reporting and other requirements. The rules of that exchange permit membership to any broker-dealer doing a "general" and "public" securities business, with more than half of the revenues derived from other than affiliates.

Institutional membership has been sought primarily by those institutional investors, such as insurance companies and advisers to investment companies sold by captive sales forces, which could not avail themselves of reciprocity with broker-dealers. The potential loss of reciprocity to banks and investment advisers because of antitrust actions could have two possible consequences. Many of these institutional investors deprived of their significant source of reciprocal income may decide to affiliate with a broker-dealer with the intent of directly receiving income from commissions paid by their customers which they have received indirectly in the past. Others may decide not to affiliate but may exert pressure on the exchanges, the Commission and others to take action to reduce commissions. The unequal membership rules of the exchanges has led to a trend toward institutional investors joining some regional exchanges and placing orders away from the primary market in New York. As long as the NYSE has a minimum commission rate which the institutional investors believe to be too high, and as long as the NYSE prohibits these institutional investors from membership, it is probable that this trend will not only continue but will accelerate.