

Roth, Gerard & Co.
New York, New York

February 27, 1968

Mr. Orval L. DuBois, Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Dear Mr. DuBois:

This letter presents our position on the Commission's proposed Rule 10b-10 and the New York Stock Exchange proposal on the commission rate structure.

We first address ourselves to the following SEC statement:

"Any consideration, both of these proposals and of the practices and procedures to which they relate, must include careful attention to their impact upon competition, including competition among securities firms, competition among markets and competition among institutional investors. This is mandated by the antitrust laws and the policies underlying these laws."

SEC Release No. 34-8239, January 26, 1968; page 1. The underlining is ours.

We believe Rule 10b-10 would substantially reduce competition at all levels of the securities industry and work towards the elimination of smaller firms to the advantage of larger ones. NASD figures (Economic Consequences for the Securities Business, Tables 13 and 14, pages 31 and 33) indicate quite clearly that give-ups tend to flow from larger firms to smaller ones and represent a far more significant portion of operations to smaller firms. The Commission confirms this with the statement:

"The abolition of customer-directed give-ups would appear to have only a slight effect on the gross income of the securities industry ... Gross income from give-ups and reciprocals from all sources exceeded 5 per cent of gross income for only one size group of broker-dealers -- the 37 dealers whose gross income ranged from \$185,000 to \$200,000 in 1964."

Report of the SEC on the Public Policy Implications of Investment Company Growth, HR No. 2337, December 2, 1966, page 186.

The give-up has stimulated competition by allowing greater access to the growing institutional market for many new small, and aggressive firms over the

past ten years. This is because the give-up enhances a small firm's ability to offer specialty service without commitment of very substantial capital and management inputs and correspondingly high overhead associated with full line brokerage (apart from Exchange memberships). Unlike many businesses, a small firm has the opportunity to compete in the securities industry because quality and efficiency of some service aspects are not affected by volume or scale economies. For instance, research competence often depends on the effectiveness of a single individual. Many services provided by smaller firms are sharply differentiated or unavailable from larger organizations.

To many institutions, opening of what has traditionally been a business dominated by large, older line firms has been a welcome source of highly useful and often creative services. Where elimination of give-ups result in a reduced number of small units, we feel the range of services available to institutional investors would diminish as well. Further, analysis of reasons for growth of regional exchanges leads to the conclusion that abolition of customer-directed give-ups would severely reduce the scope, of those operations in favor of the New York Stock Exchange.

Rule 10b-10 appears to grow out of the Commission's strong desire to eliminate give-ups used to motivate or reward broker-dealers for selling fund shares. If the Commission can demonstrate that such usage is unwarranted and desires to eliminate such practice, then it should specifically prohibit additional compensation for sales of fund shares. As it is, many large firms are compensated for fund share sales through direct order placement, not give-ups, so that eliminating give-ups would discriminate against smaller firms without accomplishing the Commission's apparent intent.

In its eagerness to do away with the practice of reciprocal income in the form of give-ups for the sale of fund shares, the Commission would make it extremely difficult for funds to compensate for other essential services to which the Commission is not primarily objecting. Moreover, mutual funds are only a part of the institutional market, and the Commission implies it may require elimination of give-ups for all investors. While give-ups for fund sales may arouse the SEC's concern, this is not a problem for investors other than mutual funds.

We believe methods of doing business arise in response to real economic needs, and that change within the framework of established practice is preferable to elimination of practices by fiat. For this reason, we are more favorably disposed to the New York Stock Exchange proposals although we hardly agree with them across the board.

In order to place our views in perspective, a definition of the Firm's business is helpful. Roth, Gerard & Co. (a New York Stock Exchange member) neither

solicits nor accepts business from the general public with the exception of relatives and close friends of the partners which generates about 5% of net revenues. No "salesmen" in the usual sense are employed and we have never sold a mutual fund share. Roughly 90% of net revenues is from institutional or corporate clients (about half of this from mutual funds). The remaining 5% of revenues is from interest and dividends generated by the Firm's investment account.

Out of the broad range of services provided by the Exchange Community we specialize exclusively in research for institutional investors. Since the Firm was founded in 1961, virtually all income has derived from research in the entertainment industry (principally motion pictures and television). Compensation is for continuous and detailed industry and company coverage, special projects, and specific securities recommendations. After three years of intensive and uninterrupted research in the copper industry and copper company securities, an associate initiated institutional calls early in 1967 and is just now beginning to produce meaningful income. One partner has been researching railroads and railroad securities for almost four years. We estimate our investment in copper and railroads expertise will total close to \$250,000. This is a willing input on our part in the hope of building future earning power based on an unusually high competence required to establish and secure an institutional clientele. With this goal in mind, neither our copper nor our railroad man attempted to generate any revenue from the developing knowledge of industry or company economics, pending sufficient preparation to insure the work is up to the standard of our entertainment effort. In addition to two partners and an associate, the Firm has four female employees (one part time) who handle secretarial, switchboard and bookkeeping functions; one is a registered representative who oversees communication of orders to Hayden, Stone Incorporated, through whom we clear on a fully disclosed basis.

A major and increasingly significant proportion of Roth, Gerard & Co.'s income comes from customer-directed "give-ups." In 1967, roughly 42% of net operating revenues were received in give-ups as compared with 26% in 1966; 35% of 1967 payments were from institutions other than mutual funds. We believe revocation of give-ups would significantly affect our ability to do business with many clients. Institutions might find it undesirable to place business with a large number of small firms such as ourselves as compared with the administrative and execution efficacy of dealing with large firms whose specialty is executions. If we were to receive gross commissions in an equal volume to presently received give-ups, the Firm would lose that portion of the commission payable to our clearing agent and would incur additional administrative expenses.

We believe there is some confusion as to the services purchased by a commission. Proposed Rule 10b-10 is built on the assumption that a commission should be used only to compensate for order execution.

"The recipient of a 'give-up' check may have had nothing whatsoever to do with the transaction for which the commission is charged and in fact may not even know of the transaction or where or when it was executed."

SEC Release No. 34-8239, January 26, 1968, page 3.

Perhaps commissions were solely related to physical execution many years ago but there is abundant and compelling evidence in current retail and institutional practice that the commission presently pays for a universe of services. If this is so, then there is nothing wrong with the recipient of a give-up check having no knowledge of the order from which the give-up results; the executing broker often does not know how the transaction is initiated, and does not care. The following SEC statements seem to recognize that the execution function cannot be isolated from other investment services:

"The commissions prescribed by the exchanges pay for more than the execution and clearance of transactions. Those commissions also compensate exchange members for soliciting brokerage business and for services ancillary to the brokerage function. Those ancillary services include furnishing investment research and recommendations to public investors. Indeed, the advisory and other services that brokerage firms customarily provide without separate charge constitute a part of the competition for investor patronage."

Report of the SEC on the Public Policy Implications of Investment Company Growth, HR No. 2337, December 2, 1966, page 163. The underlining is ours.

"These institutional transactions generally do not involve the payment of a commission to a salesman of the broker, although an institutional brokerage business usually does entail the expense of maintaining an institutional trading department and the development of special talents."

SEC Release 34-8239, January 26, 1968, page 2. The underlining is ours .

It is our experience that research constitutes a most important "special talent(s)" as the phrase is used above. The development and execution of an order often is the product of research and further involves custodial services, communication facilities and other costly and time consuming activities quite apart from physical execution and clearance. We argue that these activities together constitute services provided for a single commission. However, the best of all these services are not generally available from a single firm, and the give-up allows an

institution to benefit from specialization offered by each of a number of different firms through the use of a single commission. One might persuasively demonstrate that the use of give-ups is a de facto form of volume discount. The commission appears to agree with this viewpoint:

"Give-ups and reciprocal business practices in connection with institutional trading have become so widespread that it may plausibly be argued that, in the case of large institutional orders, there is in economic substance no fixed, minimum commission."

SEC Release No. 34-8239, January 26, 1968, page 4.

We feel the following statement is at best incomplete, and at worst inaccurate :

"While orders to buy or sell large blocks involve greater demands on a broker than the execution of a single round lot order, it does not cost a broker anywhere near 100 times as much to execute a 10,000 share order than to execute a 100 share order. Indeed, for certain aspects of the execution process, such as bookkeeping, the cost is essentially the same."

SEC Release No. 34-8239, January 26, 1968, page 2.

We object to the Commission's isolating only the most profitable part of the business for discussion without reference to the entire spectrum. The Commission takes into account only the direct out-of-pocket costs of executing an order, without applying the substantial research, travel, selling and overhead factors required to initiate the transaction, although it further on gives some recognition to other costs in the phrase quoted above on page 6, mentioning "the expense of maintaining an institutional trading department and the development of special talents." Use of a narrow out-of-pocket cost definition would indicate high profitability for any business with large indirect or fixed expenses. On a fully allocated basis, the cost of orders will vary widely, depending on the total services required to initiate and complete a transaction. Our experience is that a year or more may elapse between the time research service is initiated and compensation received, from a given account, making a realistic allocation extremely important in judging profitability. While it may well be true that large institutional orders are highly profitable even after applying real costs, it may be equally true that smaller orders are extraordinarily unprofitable. If this were to prove the case, we wonder whether the Commission is prepared to permit substantial upward adjustment in the commission rates on small orders at the same time it is advocating reduction on large transactions.

As stated in our summary, we are more favorable to the New York Stock Exchange proposals than to Rule 10b-10, although not in agreement on all

points. On the subject of volume discounts, we urge an examination of the entire rate structure, as opposed to an isolated sector, if a volume discount is justified then it certainly should be instituted; if it is also apparent that there should be a simultaneous upward adjustment in small lot commissions, then this should be part of an entire commission package.

While we obviously concur with the Exchange position on customer-directed give-ups, we see no reason to place a limitation on the amount which may be given up. We believe that economics will keep an effective limit on how much a firm will give up. While the Commission stresses that some "lead" brokers retain only 25% of commissions, this is entirely voluntary since no broker is required to give-up any part of a commission. We believe "lead" business is quite profitable, largely because the executing broker bears only the out-of-pocket clearing cost, and is free of the expense associated with originating the order.

The New York Stock Exchange proposes that the Commission join with it in establishing give-up policy for all exchanges. As members of the NYSE and no regional exchanges, we would still prefer to have the NYSE establish its own rules in competition with other markets. While the Commission makes much of the probability that the NYSE proposals would have a significant impact on regional exchanges, there is no mention of the fact that Rule 10b-10 would be disastrous for the regional markets. As far as "institutional membership" on exchanges is concerned, we are against its prohibition by law. However, we would favor some mechanism which would insure against potential conflict of interest between the management company and fund shareholders where orders are placed through a broker-dealer affiliate.

We are concerned that Roth, Gerard & Co. may be caught in the backlash of the SEC's desire to rid the industry of reciprocal income in the form of give-ups for sale of mutual funds. As indicated earlier, if the Commission can demonstrate that this practice should not be permitted to continue, it should be abolished. However, there seems no reason for the Commission to destroy what we consider to be the constructive aspects of the give-up mechanism in the process. We are prepared to meet and cooperate with the Commission and make financial information about the Firm available on a confidential basis in order to support our position on give-ups. We appreciate the opportunity to present our views on a matter so urgently important to the Firm.

Sincerely,

Emanuel Gerard
Partner

Alan Roth

Partner