

EXAMINATION - GEORGE WASHINGTON UNIVERSITYSECURITIES REGULATION

Prof. Rotberg

ANSWER ANY THREE QUESTIONS.

1. You are a Governor of the New York Stock Exchange.
  - (a) Prepare a memorandum explaining why you are opposed to institutional membership;
  - (b) Answer and refute your own arguments.
  
2. You own shares in a mutual fund and favor negotiated rates commencing at orders in excess of \$100,000 on the New York Stock Exchange.
  - (a) What forum do you choose to seek relief and explain why.
  - (b) What substantive arguments do you make?
  
3. You are a financial analyst and have recently received the Merrill Lynch Prospectus relating to the sale of their common stock to the public. Prepare a complete financial analysis of Merrill Lynch's stock for your public clients, paying specific attention to the potential regulatory environment and product mix which might affect Merrill Lynch, favorably or unfavorably, in the future.
  
4. You are an Attorney in the Anti-trust Division of the Department of Justice. Prepare a position paper on the major problems which you believe now require or will require direct attention and intercession by your Department in the Securities industry, including, but not limited to, recent developments affecting financial capacity and resources available to broker dealers.
  
5. You are the President of a regional stock exchange. State what specific steps you recommend to your Board at this time on the following subjects:  

Reciprocal business; Volume discounts; Institutional membership; Public ownership; and Negotiated rates.

State specifically what risks you take by your actions and how the New York Stock Exchange and the Securities and Exchange Commission would likely respond.
  
6. Answer last year's examination question.

FINAL EXAMINATION

SECURITIES MARKETS REGULATION

Prof. Rotberg

The New York Stock Exchange has adopted a new rule imposing a minimum charge of \$15 per transaction for each order up to 1,000 shares executed on the Floor of the Exchange but not to exceed 50% of the present commission rate schedule. (In effect this means that for 100 shares trading in excess of \$23, the \$15 minimum charge is applicable). The Commission, after receiving the proposed rule change, issued a release stating as follows:

"The Securities and Exchange Commission today announced its response to the proposed rule of the New York Stock Exchange imposing a surcharge on the applicable commission. The Commission's action was predicated and conditioned upon the fact that it is vital to the public interest that small investors continue to be able to participate directly in equity investment, that they have access to exchange markets and that needed capital be retained within the securities business. The Commission, therefore, expects that the exchanges will take all steps necessary to assure that full brokerage services to small investors are restored and that transaction size and other limitations on accounts of such investors which were imposed in the last year by a substantial portion of exchange membership will be removed."

"The Commission is aware of the contribution of small investors to the depth and liquidity of our trading markets and considers it to be vital to the public interest that such investors continue to be able to participate directly in equity investment. We are also concerned with the financial problems of the industry and the losses sustained in the past year and during the first quarter of 1970. Accordingly, we will not object to the Exchange imposing an interim surcharge on rates to provide emergency financial relief while more fundamental alterations of the existing rate structure can be considered."

You are a "small investor" and are opposed to the \$15 charge. Your reasons and argument are as follows:

(a) As far as you are concerned the \$15 charge will reduce, rather than increase, the possibility of your buying listed securities through member firms for execution on the New York Stock Exchange. You argue that it is less expensive for you to go to a non-member dealer and buy or sell the security in the third market and not be charged a \$15 transaction fee by your broker, or to purchase securities other than those listed on the New York Stock Exchange.

(b) If the \$15 charge was designed to provide an economic incentive for member firms to solicit and service your listed business, then such charge is insufficient because of the greater incentive available to member firms and their salesmen to merchandise investment company shares at considerably higher compensation.

(c) The member firm maintaining your account has been offering you excellent advice and service.

(d) Such member firm is willing and able to execute your orders and service the account without the \$15 charge but is required to levy such charge under the rule.

(e) If other firms require increased rates or charges (a) to assure a reasonable opportunity for profit and (b) to continue to service small investors who may wish to continue receiving quality advice and service for listed securities, then such firms should be permitted to levy a maximum charge of \$15 without obligating all firms to levy a minimum charge of \$15.

(f) If brokerage firms require resources to provide operating capital, they should "go public" and raise working capital from shareholders and not from investors who cannot subject such firms to price competition, and/or restrict the freedom of existing shareholders or partners to withdraw their capital.

(g) The largest brokerage firms with the most branch offices stand to profit the most from the \$15 charge, both in absolute terms and as a return on capital, or as a percent of gross income, thereby giving them more-economic leverage against smaller broker-dealer firms and greater possibilities to subsidize other aspects of their business vis-a-vis smaller member and non-member firm competitors.

(h) Non-member firms cannot agree to levy a fixed minimum charge because Section 15A(b)(8) of the Exchange Act of 1934 does not permit the [National Association of Securities Dealers] to "impose any schedule of prices, or to impose any schedule or fix minimum rates of commission, allowances, discounts, or other charges."; therefore, the \$15 minimum for the reasons set forth in "g" above unfairly discriminates against such non-member firms.

(i) Since many of the larger member firms are experiencing financial difficulties, some quite serious, a maximum \$15 charge (as distinguished from the \$15 mandatory minimum charge) would not likely cause "destructive price competition". In this connection, many firms unilaterally instituted their own minimum service charges, dropped the reduction of \$2 per trade for odd lots and have not been subjected to "destructive price competition" from those firms who have not taken such steps.

(j) You were given no opportunity to be heard by the Securities and Exchange Commission who asked for no public comment prior to the issuance of its release.

(k) Inasmuch as there are no restrictions as to branching, nature of expansion, use of capital (other than those imposed by net capital rules), the \$15 charge will offer brokerage firms an incentive to expand or at least not contract their business activity thereby causing unnecessary and inefficient duplication of effort through the maintenance or increase of the number of branches of brokerage firms in any given area. It also will tend to delay tightening up of expenditures - particularly of firms with many branches who service retail customers. This in turn would be of no benefit to the small firm, its larger competitor or the small investor.

(l) Though you have not seen the evidence, you argue that the SEC's conclusion apparently is based on operating statements of member firms and is meaningless because (a) the expenses allocated to the securities business are inaccurate and unreliable between firms; (b) the operating statements were based on an unusually adverse 6 month period characterized by instability in credit markets, disintermediation, tight fiscal controls, etc. and did not reflect the profitability of brokerage firms over a longer period particularly in 1967 and 1968; (c) many of the costs are geared to fixed and non-competitive rates (e.g. the intra member rate) and other costs are incurred in connection with reciprocal relationships which should not be considered in evaluating the reasonableness of a fixed charge, which by its nature contemplates a non-rebative cost structure; (d) even if there are overall losses for firms as a whole (thereby making irrelevant the allocation of expenses to the securities business), such losses arise from activities other than the securities commission business, i.e. trading and investment losses in a bad market year; (e) even if it is the commission business which causes the losses, many firms who had such losses do a relatively small proportion of the overall commission business.

(m) Even if the foregoing is not true, i.e. assuming that many firms are unprofitable who are primarily in the retail commission business and such activity is the cause for their overall operating

losses, and these firms do a substantial portion of the overall retail business with the public, other firms who are ready and willing to service the public are profitable and willing to take and service small accounts.

(n) Even if all are unprofitable and unwilling to service small investors, you haven't seen the proof or data nor have you been given an opportunity to comment on it.

(o) If you had seen the data there is nothing about any given pattern of the profitability or lack of it which requires the imposition of a fixed minimum charge "to make the Exchange Act work".

(p) The Commission has never articulated the judgments - political, social and financial - which enable you to oppose or support mandatory charges, such as the one at issue, either in terms of the proof of the underlying facts or the validity, wisdom or appropriateness of the value judgments relevant to their decision.

The foregoing is your position.

QUESTION:

1. What forum(s) do you use to make these points? Explain precisely how you intend to get relief. (25%).

2. You are counsel and advisor to New York Stock Exchange. You believe that the arguments and implications therefrom have no merit or validity. Refute each point. (75%).