PART II

The SEC Has a Little List

It's throwing some explosive new ideas at Wall Street, and the Street doesn't like them a bit.

by Carol J. Loomis

The drawing on the opposite page admittedly caricatures the situation somewhat, but there is no doubt that the Securities and Exchange Commission has been having some strenuous arguments with Wall Street lately. There is also no doubt that the SEC has, in general, been winning the arguments; as the drawing suggests, the New York Stock Exchange and its soon-to-retire president, G. Keith Funston, came off rather badly in one recent collision over an Exchange rule. The arguments have not just been with the exchanges either. The Commission has taken on the rest of the Wall Street establishment as well: the over-the-counter market, the mutual funds, and—behind them all—the large network of broker-dealers that make their living in the securities business. The arguments began a few years ago, when the SEC's *Special Study of the Securities Markets* laid out in detail the problems of the industry as they were viewed from Washington. But in the last year—and especially in the last month, with the release of the SEC's long-awaited mutual-fund report—the industry has come to see how determined the SEC is to gain its objectives, and how sharply these collide with the Street's established ways of doing business.

By FORTUNE's estimates, broker-dealers and investment advisers of mutual funds in the U.S. are currently realizing gross revenues of about $5 billion a year. Of this, at least $350 million—most of it clearly identifiable as profits—is now imperiled by one or another of the SEC's proposals. Which helps to explain why the proposals will be bitterly contested—more bitterly even than the Commission's drive for increased corporate disclosure (which was described in Part I last month).

Chairman Manuel F. Cohen of the SEC has insisted repeatedly that it is not "at war" with Wall Street. What Cohen wants is more and better "cooperative regulation," a concept promoted by the *Special Study* as an improvement on Wall Street's traditional "self-regulation." The idea is that the Street's own institutions should cooperate with the SEC to ensure that the securities markets are operated in the public interest. But the fact is that cooperative regulation seems always to break down when it begins to threaten the pocketbooks of the regulated.

Some unexploited inconsistencies

While the Street is clearly prepared to fight, it has been discovering that many of the Commission's proposals are difficult to attack. Each has been put forth as the answer to a specific problem, and each has a certain interior logic. When these proposals are viewed as a package, to be sure, a number of inconsistencies become apparent. The biggest concerns the Commission's approach to price competition in the industry. Some of the SEC's new programs and declarations seem to rest on a belief that more price competition in the exchange markets would advance the public interest; some even seem to suggest that the "minimum commission" rules of the exchanges are in danger. And yet, another major proposal, this one concerning the mutual-fund business, rejects the notion of price competition and instead takes the SEC into price fixing.

The industry has found it difficult to exploit these inconsistencies, mainly because it devoutly wishes to be spared either alternative, price fixing by the SEC or real competition on its prices. Instead, it is arguing that the SEC is wrong in thinking prices should come down at all. The SEC's position, the industry says, mistakenly equates "cheaper with better," when in fact the Commission should be recognizing that the public interest is best


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RULE 394
BROKER-DEALERS

served by a strong and profitable securities business. "This is a delicate mechanism they're fooling with," one industry leader said recently. "If they insist on squeezing profits, there's no telling what damage might be done."

Actually, the SEC agrees wholeheartedly on the need for a strong and profitable securities industry. The question is *how* profitable. On this crucial point, the industry and the SEC seem to be at least $350 million apart.

The importance of oversight

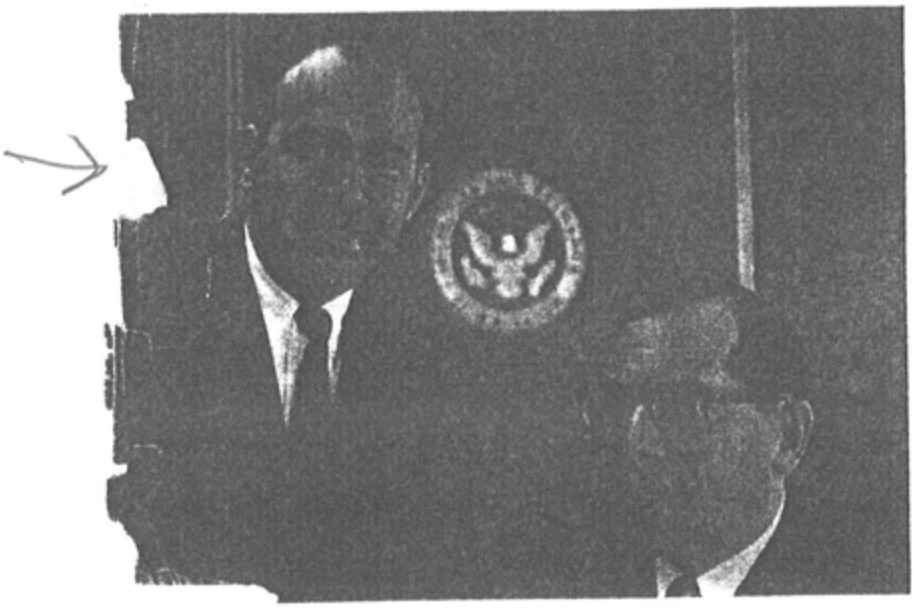
Some of the issues that divide them originate in the rules of the New York Stock Exchange. Recently, two private suits attacking the N.Y.S.E. have served to clarify the legal status of its rules and also the relationship between the Commission and the Street. Both suits were based on the antitrust laws. In the first suit, which the Big Board lost after going all the way to the Supreme Court, an over-the-counter dealer named Silver charged that the Exchange had summarily ordered several of its members to remove quotation wires that had been hooked up between their offices and his own. The second antitrust suit, the so-called Kaplan case, was decided in the Exchange's favor last summer (although it has since been appealed). In this suit, some mutual-fund shareholders attacked the Exchange's minimum-commission rules, charging that their funds had been overcharged because they were forced to pay "fixed" rates. The suits made several things clear. Taken together, they established that the SEC's authority to oversee most rules of the Exchange, including the reasonableness of commission rates, gives the Exchange considerable protection against antitrust suits. This finding was greeted with considerable relief by the SEC: it has its own quarrels with the Exchange's rules, particularly those that apply to rates, but it doubts very much that antitrust suits are an appropriate way to get improvements. With this matter clarified, the SEC could get back to seeing that its own authority over rates was adequately exercised.

At the same time, the Silver case made it clear that the Exchange's antitrust exemption has its limits. The Exchange's vulnerability to antitrust suits was held to be greatest in areas where its actions are not being monitored by the SEC. To some extent, then, the antitrust suits have made the Exchange somewhat more willing to accept the SEC's regulatory attentions; meanwhile, the suits have worked to stimulate the SEC's interest in some areas previously neglected.

The latest such area involves the Exchange's recently amended Rule 394. This rule used to say that members of the Exchange could not, without special permission (which was rarely given), transact business in listed stocks off the Exchange; in other words, they could not freely deal in these stocks over the counter. The rule made it certain that trading in listed stocks would be concentrated on the Exchange and would be conducted at regular commission rates.

But Rule 394, operating in conjunction with the minimum-commission rules, led eventually to the creation of the so-called "third market," in which large broker-dealers that are not member firms—Weeden & Co. and First Boston Corp. are prominent examples—make their own markets in listed stocks. These dealers handle only a limited number of stocks, but they are practically always ready to trade in them at prices that will allow a buyer or seller to do slightly better than he could on the Exchange. In effect, these better prices simply mean that the third-market dealers are undercutting the commission rates charged on the Exchange.

The SEC's interest in the relationship between Rule 394 and the third market was sparked by the *Special Study*, which urged the Commission to give further study to certain elements in the market that seemed to limit competition and detract from investors' ability to get "the best execution" of any particular transaction. The problem with 394, as the Commission grew to see it, was that it prohibited Exchange members from getting their



Patrolling the Street

Many of the proposals now agitating Wall Street came out of the offices of these three senior staff men at the SEC. At the left, associate director Eugene H. Rotberg and director Irving M. Pollack of the Division of Trading and Markets have been closely identified with the Commission's drive to get volume discounts on the exchanges and more disclosure about sales charges in the over-the-counter market. Rotberg also monitored the SEC's campaign to force the Big Board to amend its controversial Rule 394. Philip A. Loomis Jr., right, general counsel of the SEC, was asked in mid-1965 to take over and speed up the Commission's mutual-fund study. He will also have a prime responsibility for trying to get the Commission's recommendations through Congress.