Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets

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This Article examines the emergence of modern regulation of information flows in securities markets in the form of restrictions on insider trading and Chinese Walls within financial intermediaries in the 1960s – early 1970s. It is argued that this regulatory development can only be understood in the context of the demise of the fixed brokerage commissions regime on the New York Stock Exchange and other securities exchanges and the corresponding use of inside information by brokers as a means of obtaining brokerage revenues. This Article maintains that the overall enforcement program of the SEC – that led to insider trading regulation and the creation of Chinese Walls and included such seminal decisions as Cady, Roberts *and* Merrill Lynch *– was strongly influenced by the existence of the fixed brokerage commissions regime and the related concern about the representation of financial institutions on corporate boards. This Article also examines the historical experiences of the fixed brokerage commissions regimes in the United Kingdom and Japan and argues that such price restraints had strongly influenced the insider trading practices and regulation of information flows in these countries.*

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* The author thanks Henry G. Manne for suggesting the topic and his continuing guidance in life and Michael S. Barr, Taja M. Beane, Thora P. Becker, Omri Ben-Shahar, Phyllis Benison, Matthew Champagne, Laurence D. Connor, Stuart Glass, Ingrid A. Gregg, Michael Grey, Virginia Harnisch, Evander Harris, John D. Heine, Jermaine Jones, Leonard P. Liggio, Janet Linde, Ranald C. Michie, Cyril Moscow, Vincent F. Murphy, Jonathan Pitt, Cynthia R. Plisch, Selinda Ravenell, Larry E. Ribstein, Barry A.K. Rider, William Roach, David S. Ruder, Mark P. Siford, Priscilla Tacujan, Bettina Thorpe, Steven Wheeler, Sandra Zeff, as well as the Atlas Economic Research Foundation, the Chicago Board Options Exchange, the Earhart Foundation, the Institute for Humane Studies, the John M. Olin Center for Law and Economics at the University of Michigan Law School, the New York Stock Exchange, and the U.S. Securities and Exchange Commission for their help, support, and expertise.

INTRODUCTION

The significance of the regulation of insider trading[1] and the existence of Chinese Walls within financial intermediaries[2] is beyond dispute. Yet, there is no clear answer why these regulatory features of securities markets[3] – among the most important ones since the emergence of the system of mandatory disclosure – materialized in the United

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[1] "Insider trading" generally refers to transactions in company's securities by corporate insiders or their associates based on information originating within the firm that would, once publicly disclosed, affect the prices of such securities, although the border between "inside" and "outside" information is blurry from both the economic and regulatory perspectives. *See generally* Stanislav Dolgopolov, *Insider Trading*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS (David R. Henderson ed., 2d ed. forthcoming 2007). For a selective mix of sources examining different aspects of the insider trading controversy, see HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING (2d ed. 2005); Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002); Arturo Bris, *Do Insider Trading Laws Work?*, 11 EUR. FIN. MGMT. 267 (2005); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983).

[2] A "Chinese Wall" is defined as "a self-enforced informational barrier consisting of systematic, as opposed to *ad hoc*, procedural and structural arrangements . . . designed to stem the flow of knowledge (in particular, unpublished price sensitive information) between different divisions within a multi-capacity financial intermediary with conflicting interests and obligations." HARRY MCVEA, FINANCIAL CONGLOMERATES AND THE CHINESE WALL: REGULATING CONFLICTS OF INTEREST 123 (1993). For other representative works on Chinese Walls, see RALPH C. FERRARA ET AL., FERRARA ON INSIDER TRADING AND THE WALL chs. 9–10 (2006); Martin Lipton & Robert Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459 (1975); Norman S. Poser, *Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the U.S and the U.K.*, 9 MICH. Y.B. INT'L LEGAL STUD. 99 (1988).

[3] These two regulatory developments were interrelated: "[T]he concept of the Chinese Wall was created as a preventive measure to control the specific problem of misuse of inside information by multi-service securities firms." Poser, *supra* note 2, at 103.

States in the 1960s – early 1970s without relevant amendments to the federal securities statutes.[4] The historic and economic context of *Cady, Roberts*[5] and *Merrill Lynch*,[6] the seminal decisions of the U.S. Securities and Exchange Commission that gave rise to the complex framework of insider trading regulation and internal informational barriers within financial intermediaries, respectively, is not well understood. Rule 10b-5,[7] the principal regulatory tool against insider trading that emerged during that time period,[8] was initially designed by the SEC to reach clear fraud rather than trading on superior information in impersonal securities markets or transmission of such information within financial intermediaries to secure trading gains for themselves or their clients.[9]

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[4] On the other hand, the federal government had expressed concerns about insider trading practices as early as 1900, when a high-level study group observed that "the officers and directors of large combinations [sometimes] have taken advantage of their inside knowledge of business to speculate on the stock exchange in their own securities to the great detriment of the other shareholders." U.S. INDUS. COMM'N, PRELIMINARY REPORT (1900), *in* 1 REPORTS OF THE INDUSTRIAL COMMISSION 34 (1900-02).

[5] Cady, Roberts & Co., 40 S.E.C. 907 (1961). For the discussion of this decision, see MANNE, *supra* note 1, at 37–39; F. Arnold Daum & Howard W. Phillips, *The Implications of* Cady, Roberts, 17 BUS. LAW. 939 (1962); Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319 (1999); Jack M. Whitney II, *Section 10b-5: From* Cady, Roberts *to* Texas Gulf*: Matters of Disclosure*, 21 BUS. LAW. 193, 198–200 (1965).

[6] Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968). For the discussion of this decision, see FERRARA ET AL., *supra* note 2, § 9.02[1]; Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1618 (1990); Poser, *supra* note 2, at 105–06, 127.

[7] Exchange Act Release No. 3230, 1942 SEC LEXIS 485 (May 21, 1942) (adopting then-named Rule X-10B-5).

[8] *See* FERRARA ET AL., *supra* note 2, § 1.02[1][b] (stating that "[p]resent-day liability for insider trading stems primarily from Section 10(b) of the Exchange Act and SEC Rule 10b-5 thereunder") (footnotes omitted). Before Rule 10b-5 became the main means of pursuing insider trading, its place was occupied by section 16(b) of the Securities Exchange Act of 1934, Pub. L. No. 290, 48 Stat. 881, 896, that only prescribed disgorging profits of directors, officers, and major shareholders from "short-swing" transactions made within six months in equity securities listed on securities exchanges. Section 16(b) had a limited scope, and its passage could be explained not just by the concern for the use of inside information but also by the goal of eliminating short-term speculative trading by corporate insiders and hence their incentive to manipulate the stock price. *See* Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391 (1991). Yet, section 16(b) had not been entirely forgotten and toothless; in fact, a contemporary commentator described it as "a constant source of litigation [and] a never-ending series of difficult questions." Arthur H. Dean, *Twenty-Five Years of Federal Securities Regulation by the Securities and Exchange Commission*, 59 COLUM. L. REV. 697, 701 (1959).

[9] For the description of circumstances surrounding the adoption of Rule X-10B-5 by its principal drafter, see Milton V. Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967). Analyzing the SEC's position during congressional hearings, Professor William H. Painter concluded that "it is extremely doubtful that, prior to the *Cady, Roberts & Co.* case, the Commission envisaged Rule 10b-5 as having any real application to insider trading beyond the fraud area." WILLIAM H. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE §5.09, at 223 (1979). *See also* Note, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950) (analyzing the early jurisprudence under the Rule and discussing its applicability to insider trading).

The same time period, the 1960s – early 1970s, marked the demise of the fixed brokerage commissions regime on the securities exchanges in the United States – most importantly, the New York Stock Exchange – characterized by mandatory minimum charges for equities transactions. The much-awaited transition to fully negotiable rates occurred on the famous "Mayday" of May 1, 1975, but, by then, the price-fixing system had already been eroded by non-price competition, secret rebates, and various "Byzantine" reciprocal practices.[10] Faced with price floors on their services and the strong pressure to provide kickbacks, brokerage firms with access to inside information frequently passed such information to their preferred clients in exchange for brokerage revenues.[11] Given the existence of such practices, Professor Henry G. Manne suggested a possible link between the fixed brokerage commissions regime and the emergence of insider trading regulation: "It is possible that the SEC's original interest in a rule against insider trading arose in part from its vigorous enforcement of the fixed commission rate structure . . . . Information, as a valuable commodity, could easily be used to make rebates to favoured customers, thus upsetting the 'cartel' arrangement . . . ."[12]

Indeed, for the bulk of the examined time period, the SEC attempted to retain the fixed brokerage commissions regime or control the process of its deregulation, focusing on controlling the regime's impact on securities markets rather than the cause itself. Furthermore, the regulatory agency's enforcement actions that created insider trading regulation and Chinese Walls were in fact largely aimed at the insider trading practices created or magnified by the existence of the fixed brokerage commissions regime.[13] These enforcement actions were also reinforced by the much older concerns about the

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[10] The most readable and fascinating account of the demise of the fixed brokerage commissions regime on the NYSE is CHRIS WELLES, THE LAST DAYS OF THE CLUB (1975). For another excellent presentation of this subject, see JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE chs. 11–13 *passim* (3d ed. 2003).

[11] *See* DANIEL JAY BAUM & NED B. STILES, THE SILENT PARTNERS: INSTITUTIONAL INVESTORS AND CORPORATE CONTROL 30 (1965) ("If significant corporate news becomes known to a broker, he will, of course, be inclined to use it . . . . [T]hat brings him business, [not] the fact that he charges lower commissions than his competitors, for this he is not permitted to do."). *See also infra* Section I.C.

[12] Henry G. Manne, *Insider Trading*, *in* 2 THE NEW PALGRAVE DICTIONARY OF MONEY & FINANCE 416, 416 (Peter Newman et al. eds., 1992). The link between the fixed brokerage commissions regime and the emergence of insider trading regulation is also addressed in Henry G. Manne & Joseph J. Bial, *Questioning the SEC's Crusades*, REGULATION, Winter 2001, at 8.

[13] *See infra* Part III.

representation of financial institutions on corporate boards[14] and the flow of information within such institutions.[15]

This Article argues that the emergence of modern regulation of information flows in securities markets can only be understood in the context of the fixed brokerage commissions regime in the 1960s – early 1970s. Part I examines the historical experiences of the fixed brokerage commissions regime on the New York Stock Exchange and argues that its downfall was due to the rise of institutional investing and alternative trading venues as well as numerous reciprocal practices and payoffs that were often critically scrutinized by the regulators. Part II examines the background and significance of the *Cady, Roberts* decision and asserts that its factual circumstances suggest a clear connection between the use of inside information and the existence of the fixed brokerage commissions regime. Part III argues that the overall enforcement program of the SEC that led to insider trading regulation and the creation of Chinese

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[14] The first serious assault on board representation of financial institutions, as an alleged means of exercising control over the economy, occurred during the famous Money Trust Investigation, better known as the Pujo Hearings. *See Money Trust Investigation: Investigation of the Financial and Monetary Conditions in the United States Under House Resolution Nos. 429 and 504 Before a Subcomm. of the H. Comm. on Banking and Currency*, 62d Cong. (1912-13) [*hereinafter Pujo Hearings*]. Contemporary commentators often attacked that practice as inherently inefficient. *See, e.g.,* LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 198 (1914) ("The failure of banker-management . . . is a natural result of confusing functions of banker and business man."); WILLIAM Z. RIPLEY, RAILROADS: FINANCE AND ORGANIZATION, at vii (1915) ("Bankers . . . . are not in intimate daily contact with the great body of patrons which the railroads serve. . . . [M]any of our railroad troubles are traceable to their overweight of influence upon directorates."). The financial community claimed that this practice came into existence not because "the banker [desired] to manage the daily affairs of the corporation or to purchase its securities more cheaply than he otherwise could; but rather because of his moral responsibility as sponsor for the corporation's securities, to keep an eye upon its policies, and to protect the interests of investors." Letter from J.P. Morgan & Co. to A.P. Pujo, Chairman, Comm. on Banking and Currency, U.S. House of Representatives (Feb. 25, 1913), *reprinted in Morgan Defense In As Pujo Finishes*, N.Y. TIMES, Feb. 28, 1913, at 7. Empirical research is sympathetic to board representation of banking houses in that era. *See* J. Bradford De Long, *Did J.P. Morgan's Men Add Value? An Economist's Perspective on Financial Capitalism*, *in* INSIDE THE BUSINESS ENTERPRISE: HISTORICAL PERSPECTIVES ON THE USE OF INFORMATION 205 (Peter Temin ed., 1991); Carlos D. Ramirez, *Did J. P. Morgan's Men Add Liquidity? Corporate Investment, Cash Flow, and Financial Structure at the Turn of the Twentieth Century*, 50 J. FIN. 661 (1995).

[15] During the 1932-34 U.S. Senate hearings on financial practices, known as the Pecora Hearings after its chief counsel, Ferdinand Pecora, there was an emerging concern that, within banking houses, inside information obtained through board representation was shared for trading purposes. *See Stock Exchange Practices: Hearings Before S. Comm. on Banking and Currency on S. Res. 84 and S. Res. 56*, 73d Cong. pt. 1, at 205 (1933-34) [*hereinafter Pecora Hearings*] (Ferdinand Pecora asking George Whitney, a partner of J.P. Morgan & Co., whether information acquired by the latter as a result of his directorships was shared with other Morgan partners); *id.* pt. 2, at 814–15 (Ferdinand Pecora asking William Ewing, a partner of J.P. Morgan & Co., whether the latter's profitable transaction in the stock of Johns-Manville Co. was based on information obtained from the Morgan partners who served as directors of that company and whether he deliberately abstained from discussing Johns-Manville-related information with these partners). Both bankers denied that such information-sharing had taken place. *Id.* pt. 1, at 205, pt. 2, at 814–15.

Walls was strongly influenced by the existence of the fixed brokerage commissions regime. Part IV examines the historical experiences of the fixed brokerage commissions regimes in the United Kingdom and Japan and maintains that such price restraints had strongly influenced the insider trading practices and regulation of information flows in these countries. This Article concludes with the assertion that modern regulation of information flows in securities markets had originated to constrain the nexus of relationships within the securities industry – which was greatly influenced by the existence of the fixed brokerage commissions regime – and comments on the political-economy aspects of this regulatory development.

I. The Fixed Brokerage Commissions Regime on the New York Stock Exchange and Its Unraveling

This Part examines the historical experiences of the fixed brokerage commissions regime on the New York Stock Exchange and argues that its downfall was due to the rise of institutional investing and alternative trading venues as well as numerous reciprocal practices and payoffs that were often critically scrutinized by the regulators. Section I.A traces the origins and the subsequent development of the fixed brokerage commissions regime, as well as its impact on other securities markets, and analyzes its demise from the standpoint of economic and regulatory developments in the 1960s – early 1970s. Section I.B examines reciprocal practices and payoffs during that time period and argues that their existence – that attracted the SEC's attention – was due to the rise of institutional investing. Section I.C maintains that the fixed brokerage commissions regime created strong incentives for brokerage firms – that had numerous means of access to inside information – to pass such information to preferred clients. Section I.D asserts that the fixed brokerage commissions regime gave rise to the system of give-ups that was scrutinized by the regulators and partially served as a market for inside information.

A. *History of the Fixed Brokerage Commissions Regime*

The existence of fixed minimum charges was the cornerstone of the Buttonwood Agreement signed on May 17, 1792, which is thought to have created the predecessor organization to the New York Stock and Exchange Board organized on March 8, 1817[16] and renamed the New York Stock Exchange on January 29, 1863.[17] The parties to the Agreement promised "not buy or sell from this day for any person whatsoever, any kind of Public Stock at a less rate than one-quarter per cent. Commission [and to] give a preference to each other in our Negotiations."[18] From the moment of its creation, the New York Stock and Exchange Board also had minimum commission rates.[19] The "private club" character of the Exchange made no guarantee of admission,[20] and the restrictions on brokerage rates were also aided by the restrictions on membership.[21]

Over time, the institution of fixed brokerage commissions became engrained in the mind of the Exchange community. During the Pujo Hearings in 1912-13, Frank Knight Sturgis, a former NYSE President, used the following colorful language: "The violation of the commission law we regard as one of the most infamous crimes that a man can commit against his fellow members in the exchange, and as a gross breach of good faith and wrongdoing of the most serious nature . . . ."[22] For a private monopoly,

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[16] *Compare* Peter Eisenstadt, *How the Buttonwood Tree Grew: The Making of a New York Stock Exchange Legend*, 19 PROSPECTS: ANN. AM. CULTURAL STUD. 75, 91 (1994) (treating the signing of the Buttonwood Agreement and the formation of the New York Stock and Exchange Board as "two distinct (though obviously related) events"), *with* Richard Sylla, *The Origins of the New York Stock Exchange*, *in* THE ORIGINS OF VALUE: THE FINANCIAL INNOVATIONS THAT CREATED MODERN CAPITAL MARKETS 299, 308 (William N. Goetzmann & K. Geert Rouwenhorst eds., 2005) (arguing for the continuity between these two events, principally on the grounds that four signers of the Buttonwood Agreement were among the founders of the New York Stock and Exchange Board).

[17] For the unanimous resolution of the Exchange membership to rename their association, reflecting the frequent informal use of the name "New York Stock Exchange," see New York Stock & Exchange Board Minutes (Nov. 13, 1858 to May 9, 1863 vol.) (Jan. 29, 1863).

[18] Gordon v. NYSE, Inc., 422 U.S. 659, 663 (1975) (citing the Buttonwood Agreement).

[19] WALTER WERNER & STEVEN T. SMITH, WALL STREET App. D, at 193 (1991).

[20] A description of the New York Stock and Exchange Board states that "[n]ew members were added regularly, especially in peak trading years, but it was equally common for applications of brokers possessing the highest character and business qualifications to be summarily rejected." *Id.* at 30.

[21] On October 23, 1868, the NYSE recognized property rights in its seats as transferable assets, and, in the course of its subsequent history as a member-owned organization, additional seats were added only though the 1869 merger with the Open Board of Brokers and the Government Bond Department, other securities exchanges in New York City, the sale of seats in order to finance the construction of a new Exchange building in 1879, and the special "seat dividend" to its members in 1929. New York Stock Exchange, Inc., Facts & Figures, http://www.nysedata.com/factbook (follow "Historical" hyperlink; then follow "Chronology of New York Stock Exchange (1792-1929)" hyperlink) (last visited __).

[22] *Pujo Hearings*, *supra* note 14, pt. 11, at 840. The report of the Pujo Committee did not object to the existence of the fixed brokerage commissions regime as such, finding "the present rates to be reasonable, except as to stocks, say $25 or less in value" and arguing that governmental regulation should protect the NYSE against competition that "would lower the service and threaten the responsibility of members." REPORT OF THE COMMITTEE APPOINTED PURSUANT TO HOUSE RESOLUTIONS 429 AND 504 TO INVESTIGATE THE CONCENTRATION OF CONTROL OF MONEY AND CREDIT, H.R. REP. NO. 62-1593, at 115 (1913). The

unprotected from the competition by the government, the NYSE was very successful.[23] There might have been structural reasons explaining the existence of monopoly powers of the NYSE and hence its ability to establish price controls – such as "the scale economies of providing a continuous auction market for stocks."[24]

During the New Deal-era debates over the proposed regulation of securities exchanges, Samuel Untermyer, the former counsel to the Pujo Committee, remarked that the NYSE, as a "public institution" and a likely natural monopoly, should have its commissions "either be fixed by some governmental authority or be supervised by such authority."[25] This legislation in fact authorized the SEC to exercise oversight of "fixing of reasonable rates of commission" on securities exchanges,[26] creating a means for the fixed brokerage commissions regime to seek governmental protection. In stark contrast, the amendments passed to regulate the over-the-counter market only four years later, specifically prohibited national securities associations from adopting rules that would "impose any schedule of prices [or] fix minimum rates of commissions, allowances, discounts, or other charges."[27] This difference might be explained by the centralization of all trading on the physical floor of securities exchanges – and hence the perceived need for uniformity compared to decentralized OTC markets – as well as historical practices.

Up until the 1960s, the SEC was passive in its review of the NYSE's proposed changes to its schedule of minimum commissions, allowing the Exchange to exercise a great degree of discretion over its brokerage rates.[28] The NYSE's rate schedule also had

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Committee also observed that a "very low or competitive commission rate would also promote speculation and destroy the value of membership." *Id.* at 115–16.

[23] For the scholarly commentary that looks at the origins of the fixed brokerage commissions regime without too much negativity, see John C. Coffee, Jr., *The Role of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 36 n.107 (2001) ("At least during the late nineteenth century . . . more speculative issues were driven off the NYSE less by quality controls than by the impact of the NYSE's high-cost commission structure."); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1487 (1997) ("[W]e cannot be certain how the NYSE managed to maintain minimum commissions for over a century before the onset of regulation despite the apparent ease with which new exchanges could enter the market and compete for listings.").

[24] Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J.L. & ECON. 273, 275 (1984).

[25] *Pecora Hearings*, *supra* note 15, pt. 16, at 7705.

[26] Securities Exchange Act of 1934, Pub. L. No. 290, § 19(b)(9), 48 Stat. 881, 899.

[27] Maloney Act, Pub. L. No. 719, 52 Stat. 1070, 1071 (1938) (inserting section 15A(7) into the Securities Exchange Act of 1934).

[28] *See* SIDNEY ROBBINS, THE SECURITIES MARKETS: OPERATIONS AND ISSUES 176–77 (1966) ("Except for . . . occasional mildly negative reactions, the Commission at least until the present, has never interposed any serious objection to the rate increases that have been adopted and, by and large, they have followed the

pivotal significance because "other [securities] exchanges tend[ed] to follow it almost completely [and] the bulk of the trading volume upon these exchanges consist[ed] of [NYSE-listed] stocks."[29] It was concluded that "the NYSE minimum rate commission schedule ha[d] a substantial effect upon pricing [for agency transactions] in the over-the-counter markets."[30] In reality, the Exchange's brokerage commissions schedule dictated actual rather than minimum transaction prices: "[T]he minimum has, in practice, become a ceiling as well as a floor."[31]

Starting in the 1960s, the maintenance of the fixed brokerage commissions regime became problematic, given the rise of professional institutional investors that either "negotiated" charges by receiving non-price extras or hidden rebates from brokerage firms or switched to alternative trading venues.[32] The Exchange was losing its market share to the over-the-counter "third market" in NYSE-listed securities with no fixed charges and to regional exchanges with more lenient rebative practices.[33] Furthermore, the institutional investors created an informal "fourth market" to trade among themselves

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form of the original proposals [of the NYSE]."). For a description of the Exchange's rate increase proposals and the corresponding reactions of the SEC, see REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95, pt. 2, at 329–33, 344–46 (1963) [*hereinafter* SPECIAL STUDY].

29 John R. Johnson, *Application of Antitrust Law to the Securities Industry*, 20 SW. L.J. 536, 540 (1966). *See also* David L. Ratner, *Regulation of the Compensation of Securities Dealers*, 55 CORNELL L. REV. 348, 361 (1970) (arguing that "the NYSE commission structure determines the pattern for the industry").

30 SPECIAL STUDY, *supra* note 28, pt. 2, at 624.

31 REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 157 (1966) [*hereinafter* PUBLIC POLICY IMPLICATIONS].

32 WELLES, *supra* note 10, chs. 2–3. For other dimensions of the growing importance of institutional investing during that time period, see ADOLF A. BERLE, POWER 259–60 (1969) ("[If institutional investors] chose to exert influence on the managements of the corporations whose securities they owned (they vigorously disclaim any such intention), they would be able to make or break corporate managements at will."); PAUL P. HARBECHT, PENSION FUNDS AND ECONOMIC POWER 10 (1959) ("[T]he pension trusts are one of the primary centers of power in the newly emerging social system."). Some commentators treated the institutionalization of securities markets with a great deal of skepticism, but others favored it. *Compare* David B. Bostian, Jr., *The De-Institutionalization of the Stock Market in American Society: A Question of National Economic Security*, FIN. ANALYSTS J., Nov.-Dec. 1973, at 30, *with* Roger F. Murray, *Institutionalization of the Stock Market: To Be Feared or Favored?*, FIN. ANALYSTS J., Mar.-Apr. 1974, at 18 (1974).

33 The Exchange itself saw "unmistakable forces shifting relative volume away from the nation's central action market to regional exchanges and the so-called third market." Robert W. Haack, President, N.Y. Stock Exch., Competition and the Future of the New York Stock Exchange, Remarks at the Economic Club of New York, [1970, No. 77] Sec. Reg. & L. Rep. (BNA), at J-1 (Nov. 17, 1970) [*hereinafter* Haack's Remarks]. Regional securities exchanges were perceived as "nothing more than rebate mechanisms to get commissions to those who do not qualify or to return them to institutions." *Id.* at J-2.

to avoid any charges altogether.[34] Given the powerful forces tearing down the status quo on the NYSE and resulting numerous questionable practices of the brokerage industry, the SEC became heavily involved in the management of the fixed brokerage commissions regime, including both explicit and implicit ratemaking.[35] The surge of regulatory activism that often expended into other areas and, most likely, slowed the process of deregulation of brokerage commission, and, in retrospect, "[n]o issue did more to bring into question the historic reputation of the SEC . . . than the Commission's handling of a related cluster of stock-exchange commission-rate and membership rules in the 1963-1973 period."[36]

During the examined period, the Exchange was attacked by institutional investors, pushing for either negotiable rates or exchange membership,[37] economists seeing the fixed charges as a sign of economic inefficiency,[38] and the Antitrust Division of the U.S. Department of Justice pointing to anticompetitive practices.[39] Yet, the NYSE vehemently

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[34] *See, e.g.*, Lee Silberman, *Institutional Investors Begin Trading Stocks Among Selves*, WALL ST. J., Jan. 11, 1965, at 1 ("[The] principal motive [for direct trading among institutions] is to save the commissions they would pay if they traded through brokers. . . . [I]f commissions for large transactions were lower, institutions might be less eager to bypass [brokers] by arranging direct deals among themselves.").

[35] *See* Fixed Commission Rates on Exchange Transactions, Exchange Act Release No. 11,093, 1974 SEC LEXIS 2352, at *4–5, 9–10, 11–12, 19–20 (Nov. 8, 1974) (describing how the SEC, sometimes acting through the NYSE rather than directly, introduced a limited volume discount for orders of 1,000 shares of more in December 1968, made brokerage charges on orders of $500,000 or more negotiable in April 1971, approved a substantial discount for non-member broker-dealers in September 1971, lowered the dollar amount of negotiable orders to $300,000 in April 1972, and introduced negotiable rates for orders *less* than $2,000 in April 1974).

[36] SELIGMAN, *supra* note 10, at 382.

[37] *See, e.g.*, WELLES, *supra* note 10, at 94; Richard Phalon, *Flexible Rates Described as Alternative*, N.Y. TIMES, Mar. 3, 1971, at 57; *Prudential Will Seek Big Board Seat If Fees on Stocks Aren't Cut*, WALL ST. J., Mar. 5, 1970, at 2. *See also Institutional Membership on National Securities Exchanges: Hearings Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 92d Cong. (1972); Elkins Wetherill & George S. Hender, *Institutional Membership and the Experience of the Philadelphia-Baltimore-Washington Stock Exchange*, 13 B.C. INDUS. & COM. L. REV. 1021 (1972).

[38] *See, e.g.*, Harold Demsetz, *Perfect Competition, Regulation, and the Stock Market, in* ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 1, 19–22 (Henry G. Manne ed., 1969); Paul A. Samuelson, *Reforming Wall Street*, NEWSWEEK, Sept. 23, 1968, at 89; George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964); Richard R. West & Seha M. Tinic, *Minimum Commission Rates on New York Stock Exchange Transactions*, 2 BELL J. ECON. & MGMT. SCI. 577 (1971).

[39] *See, e.g.*, *Fixed Rates and Institutional Membership: Hearings on S. 470 and S. 488 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing and Urban Affairs*, 93d Cong. 347 (1972) [*hereinafter Fixed Rates and Institutional Membership Hearings*] (statement of Donald I. Baker, Director of Policy Planning, Antitrust Division, U.S. Department of Justice) ("The Department of Justice has long been of the view . . . that elimination of fixed rates would aid investors."); U.S. DEPT. OF JUSTICE, INQUIRY INTO PROPOSALS TO MODIFY THE COMMISSION RATE STRUCTURE OF THE NEW YORK STOCK EXCHANGE (1968) ("[Maintenance of] an effective auction market . . . does not appear to justify the fixing of minimum commission rates by the NYSE. The economic characteristics of this industry, and past experience, do not

opposed the abolition of fixed brokerage commissions. The Exchange employed economic analysis to defend the necessity of minimum commissions.[40] Furthermore, even though the NYSE was pressured to allow infusion of public capital to its member firms, it still tried to limit the access of institutional investors to its trading floor via ownership restrictions for its seat holders.[41] As the pressure for negotiable rates kept on increasing, the Exchange called for the abolition of off-board trading in NYSE-listed securities, a rather unrealistic demand, in exchange for negotiable rates.[42] Throughout the 1960s and up until the introduction of negotiable rates in 1975, the NYSE also became entangled in lawsuits to defend its fixed brokerage commissions and membership restrictions.[43] The

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indicate any significant risk of 'destructive' price levels, or adverse consequences to the exchange operation, from rate competition."), http://www.sechistorical.org/collection/papers/1960/1968_0401_USDept_Justice_Com_Rate.pdf (last visited ___).

[40] The Exchange argued that the abolition of the minimum commissions schedule would decrease the incentive to join the NYSE, weaken its self-regulation and hence reduce the level of investor protection, lead to market fragmentation among trading venues and the internalization of order flow within brokerage firms, result in destructive competition in the brokerage industry, produce industry concentration and drive smaller efficient firms out of business, result in price discrimination to the disadvantage of individual investors, and decrease the incentive of brokerage firms to provide research and other ancillary services. *See* NYSE, ECONOMIC EFFECTS OF NEGOTIATED COMMISSION RATES ON THE BROKERAGE INDUSTRY, THE MARKET FOR CORPORATE SECURITIES, AND THE INVESTING PUBLIC (1968); THE ECONOMICS OF MINIMUM COMMISSION RATES: REPLY OF THE NEW YORK STOCK EXCHANGE TO MEMORANDUM OF THE ANTITRUST DIVISION OF THE DEPARTMENT OF JUSTICE, DATED JANUARY 17, 1969 (1969). For the extensive criticism of the arguments contained in these documents, see William F. Baxter, *NYSE Fixed Commission Rates: A Private Cartel Goes Public*, 22 STAN. L. REV. 675 (1970); H. Michael Mann, *The New York Stock Exchange: A Cartel at the End of Its Reign*, *in* PROMOTING COMPETITION IN REGULATED MARKETS 301 (Almarin Phillips ed., 1975); West & Tinic, *supra* note 38.

[41] *See* WELLES, *supra* note 10, at 96–99; Baxter, *supra* note 40, at 681–82. *See also* Note, *Public Ownership of Stock Exchange Firms: Antitrust and Other Problems*, 70 COLUM. L. REV. 102, 102 (1970) (arguing that the NYSE was "fearful that true public ownership would lead to institutional [investor] control of member firms").

[42] The resolution of the NYSE Board of Directors called for "a combined program of legislation and regulation concurrently eliminating fixed commission rates on all orders and establishing the requirement that all trades of listed securities be made on registered securities exchanges operating under similar rules and regulations." *Fixed Rates and Institutional Membership Hearings*, *supra* note 39, at 437 (statement of James J. Needham, Chairman of the Board of Directors and Chief Executive Officer, New York Stock Exchange, Inc.) (quoting the resolution).

[43] *See* Gordon v. NYSE, Inc., 366 F. Supp. 1261 (S.D.N.Y. 1973), *aff'd*, 498 F.2d 1303 (2d Cir. 1974), *aff'd*, 422 U.S. 659 (1975) (alleging the illegality of the institution of fixed brokerage commissions on the NYSE); Thill Sec. Corp. v. NYSE, 283 F. Supp. 239 (E.D. Wis. 1968), *rev'd*, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971) (alleging the illegality of the NYSE prohibition on sharing brokerage commissions with non-members); Kaplan v. Lehman Bros., 250 F. Supp. 562 (N.D. Ill. 1966), *aff'd*, 371 F.2d 409 (7th Cir. 1967), *cert. denied*, 389 U.S. 954 (1967) (alleging the illegality of the institution of fixed brokerage commissions on the NYSE); Robert W. Stark, Jr., Inc. v. NYSE, Inc., 346 F. Supp. 217 (S.D.N.Y. 1972), *aff'd*, 466 F.2d 743 (2d Cir. 1972) (contesting the revocation of the NYSE membership because of a recapitalization plan giving an ownership stake to a broker-dealer affiliate of an institutional investor that had been previously denied the NYSE membership); Abbott Sec. Corp. v. NYSE, 384 F.

Exchange, in its policing of rebative practices, even considered – but did not adopt – a rule requiring all its members to report "any direct or indirect reciprocal or clearing arrangements related to New York Stock Exchange listed commission business" involving *any* NYSE member, non-member broker or dealer, or institutional investor.[44]

The regulatory and economic strains had seriously weakened the fixed brokerage commissions regime. Even the NYSE President had to admit that the retention of price controls was questionable: "[A]lthough I have argued that negotiated rates would bring about a degree of destructive competition, I now ask myself whether fixed rates have not brought about that very same kind of self-destruction [though] overly-zealous service type competition [and are] not the single greatest reason for our market fragmentation."[45] The vestige of the Buttonwood Agreement finally came to an end on May 1, 1975 when the SEC-mandated transition to fully negotiable commissions took place,[46] and the regulatory agency itself was strongly pressured by the U.S. Congress to do so.[47] The legislation that codified the abolition of the fixed brokerage commissions regime was

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Supp. 668 (D.D.C. 1974) (mem.) (alleging that the NYSE denied economic access to its floor to certain non-member broker-dealers and attempted to retain all fixed brokerage commissions on orders of institutional investors by monopolizing the market); Jefferies & Co. v. NYSE, Inc., [1971, No. 123] Sec. Reg. & L. Rep. (BNA), at D-1 (S.D.N.Y. filed Oct. 18, 1971) (contesting the denial of the NYSE membership to a broker-dealer controlled by a major institutional investor); Reinisch v. NYSE, 52 F.R.D. 561 (S.D.N.Y. 1971) (alleging the illegality of the institution of fixed brokerage commissions on the NYSE). *See also* Robert Anthony Ginsburg, *Antitrust and Stock Exchange Minimum Commissions: A Jurisdictional Analysis*, 24 U. MIAMI L. REV. 732 (1970) (discussing the limits of judicial review of the securities exchanges' rules subject to the SEC's control and the related issue of implied antitrust immunity for such rules).

[44] N.Y. Stock Exch., Minutes of the Board of Governors, pt. 10, at 1221 (Nov. 21, 1968).

[45] Haack's Remarks, *supra* note 33, at J-3

[46] The SEC took its final action abolishing the fixed brokerage commissions regime in the beginning of 1975. Adoption of Securities Exchange Act Rule 19b-3, Exchange Act Release No. 11,203, 1975 SEC LEXIS 2381 (Jan. 23, 1975). In the fall of 1974, the NYSE, along with most other leading securities exchanges, refused to abolish its fixed brokerage commissions regime, despite the SEC's request to do so voluntarily. Fixed Commission Rates on Exchange Transactions, Exchange Act Release No. 11,093, 1974 SEC LEXIS 2352, at *21 (Nov. 8, 1974)

[47] *See, e.g.*, SECURITIES INDUSTRY STUDY, REPORT OF THE SUBCOMM. ON COMMERCE AND FINANCE OF THE S. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 92D CONG. 60 (Comm. Print 1972) (arguing that "the interests of the investing public, as well as the long-term health of the securities industry itself, require that stock exchange members be free to set their own commissions on transactions effected for their customers"); SECURITIES INDUSTRY STUDY, REPORT OF THE SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, H.R. DOC. NO. 92-1519, at 143–44 (1972) (finding that "the fixed minimum commission rates are not in the public interest"); Barry R. Weingast, *The Congressional-Bureaucratic System: A Principal Agent Perspective (with Applications to the SEC)*, 44 PUB. CHOICE 147, 160 (1984) (arguing that "Congress, not the SEC, played the decisive role in NYSE [brokerage commissions] deregulation").

passed later that year.[48] In retrospect, the economic forces were responsible for this pivotal change: "The deregulation of NYSE brokerage rates followed a decade of dramatic growth in institutional trading, the evolution of low-cost alternatives to block trading on the exchange, and increased backward integration by institutional traders into the brokerage business."[49] Not surprisingly, the deregulation resulted in a marked decrease in brokerage rates for many categories of orders[50] and the price of a NYSE seat,[51] which is consistent with the idea that the fixed brokerage commissions regime allowed the brokerage industry to capture monopoly profits. Furthermore, the removal of price controls eliminated the need for many reciprocal practices of the brokerage industry,[52] although the deregulatory impetus might have created some unexpected practices of its own.[53]

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[48] The U.S. Congress prohibited securities exchanges from fixing "rates of commissions, allowances, discounts, or other fees to be charged by [their] members" with some exceptions at the SEC's discretion. Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 4, 89 Stat. 97, 107–09 (amending section 6(e) of the Securities Exchange Act of 1934).

[49] Jarrell, *supra* note 24, at 307.

[50] Empirical research indicates that the NYSE rates for all types of institutional transactions and large-sized individual transactions had declined in absolute terms from 1975 to 1980. Jarrell, *supra* note 24, at 282; Seha M. Tinic & Richard R. West, *The Securities Industry Under Negotiated Brokerage Commissions: Changes in the Structure and Performance of New York Stock Exchange Member Firms*, 11 BELL J. ECON. 29, 36 (1980). The rates for several categories of smaller orders had increased in absolute terms, indicating that, previously, smaller trades were subsidized by larger trades. Jarrell, *supra* note 24, at 282. But, taking into account inflation, probably even these rates had declined. Tinic & West, *supra*, at 35.

[51] *See* G. William Schwert, *Public Regulation of National Securities Exchanges: A Test of the Capture Hypothesis*, 8 BELL J. ECON. 128, 143–45 (1977)

[52] Yet, the introduction of competitive rates has not eliminated reciprocal brokerage practices completely, suggesting that this phenomenon is partially explained by something other than just uncompetitive pricing. For instance, the practice of "directed brokerage," i.e., directing commission business as a form of compensation for distributing mutual fund shares, has persisted. *See, e.g.*, Forsythe v. Sun Life Fin., Inc., 417 F. Supp. 2d 100 (D. Mass. 2006); *In re* Lord Abbett Mut. Funds Fee Litig., 407 F. Supp. 2d 616 (D.N.J. 2005); *In re* Columbia Entities Litig., Civil Action No. 04-11704-REK, 2005 U.S. Dist. LEXIS 33439 (D. Mass. Nov. 30, 2005); Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26,591, 69 Fed. Reg. 54,728 (Sept. 2, 2004). *See also* U.S. Sec. and Exch. Comm'n, The Roundtable of the 1963 SEC Special Study 91 (Oct. 4, 2001) (comment of Michael Eisenberg, SEC staff member, http://www.sechistorical.org/collection/oralHistories/roundtables/1963SECSpecialStudy/1963Transcript.PDF (last visited ___) ("There were give-ups, and now they're called step-outs, but they're functionally the same thing. We used to worry about interpositioning, and now you have 'introducing brokers,' and they are functionally the same thing. You used to have reciprocal business, now it's payment for order flow.").

[53] One can make an argument that the deregulation of brokerage rates, in the long run, contributed to pervasive conflicts of interest within securities firms that performed both securities research and investment banking services. *See Analyzing the Analysts: Hearings Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 107 Cong. 4 (2001) (statement of Rep. Paul E. Kanjorski, member, H. Comm on Financial Services) ("After the deregulation of trading commissions in 1975, Wall Street firms began using investment banking as a means to compensate their research departments, and within the last few years the tying of analysts' compensation

B. *Non-Price Competition Among Brokers*

The fixed brokerage commissions regime on the NYSE was frequently described as a cartel of brokerage firms holding the Exchange membership.[54] As economic theory dictates, while every participant in a cartel is interested in collective price-fixing, he also has the incentive to undercut other participants by engaging in non-price competition or secretly offering lower prices and other rebates.[55] In fact, despite the collective interest to maintain the minimum commissions schedule intact, brokerage firms were providing additional services pertaining to securities transactions at no charge[56] and engaging in reciprocal business arrangements with their customers that were only remotely related or unrelated to transactions themselves.[57] While additional services and reciprocal business arrangements, for the most part, were permitted, the NYSE combated more obvious kickbacks.[58] Of course, the boundaries between "cheating" and non-price competition

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to investment banking activities has become increasingly popular."); Stephen Barr, *The Hard Sell*, CFO, Nov. 2001, at 74, 76 ("[As a result of] the end of fixed-rate minimum commissions . . . trading fees plummeted and analyst research reports no longer paid for themselves . . . . [A]nalysts increasingly became [pressured] to attract new corporate finance clients, to promote initial public offerings on road shows, and to use their research reports to hype companies' prospects."); Kris Freiswick, *More Bricks in the Wall*, CFO, Oct. 2002, at 67, 68 (quoting A. Gary Shilling, the former chief economist of Merrill Lynch) ("May Day '75 took the fat out of the commission structure. Analysts started looking for a new trough to feed at, and investment bankers provided it."). *See also* FERRARA ET AL., *supra* note 2, § 9.04[3] (discussing the perceived need to strengthen the separation between securities research and investment banking in the wake of the 2000-02 stock market bust and the regulatory actions of the U.S. Congress, SEC, and self-regulatory organizations that mandated Chinese Walls between such functional areas in order to ensure the integrity of securities analysts' research reports).

[54] *See, e.g.*, Baxter, *supra* note 40; Jarrell, *supra* note 24; Mann, *supra* note 40; Manne, *supra* note 12.

[55] *See* ROBERT B. EKELUND, JR. & ROBERT D. TOLLISON, ECONOMICS: PRIVATE MARKETS AND PUBLIC CHOICE 283–85 (6th ed. 2000).

[56] Such services included provision of private wire and teletype services, pricing of securities portfolios of institutional investors in order to compute net asset values for sales or redemption, investment research, such as trading recommendations, overview of specific industries and companies, analysis of market trends, on-demand research, and so on. PUBLIC POLICY IMPLICATIONS, *supra* note 31, at 163–64.

[57] For mutual funds, brokerage firms distributed mutual fund shares. *See Scandal Troubles Mutual Funds*, BUS. WK., July 25, 1959, at 25, 25 (stating that the effect of informal agreements between mutual funds and brokerage companies was "to channel a mutual fund's brokerage business through the Wall Street firm in rough proportion to the amount of the fund's shares that these brokers sell"). For trust departments of commercial banks, brokerage firms held their funds at such banks. *See* WELLES, *supra* note 10, at 69 ("[B]etween 75 percent and 90 percent of bank trust brokerage . . . was allocated to particular brokers for the express purpose of generating reciprocal deposits in no-interest demand accounts."). For non-member broker-dealers operating on other exchanges or in the OTC market, brokerage firms sent orders from their own clientele for securities traded in such markets to those outside broker-dealers. *See* PUBLIC POLICY IMPLICATIONS, *supra* note 31, at 168–69; SPECIAL STUDY, *supra* note 28, pt. 2, at 302–07.

[58] For instance, the NYSE prohibited such rebative practices as favorable securities repurchase agreements; gifts and contributions to third parties; securities lending arrangements without compensation; tender

were difficult to draw. Furthermore, the existence of such "extras" clearly did not benefit everyone: "[F]or a customer lacking the leverage to negotiate such an arrangement, inclusion of the cost of ancillary services [may be forcing him to pay] for services he does not want [without the opportunity] of taking his business to another member who neither performs the unwanted services nor charges for them."[59]

The pervasiveness of non-price competition starting in the early 1960s is best explained by the growth of institutional investing and block transactions.[60] Furthermore,

> the rates were uniform *per 100 shares* [which was] [t]he critical defect . . . . [I]t obviously does not cost ten times as much to carry out an order to buy or sell 1,000 as 100 shares; if both purchases are made in a single transaction, the cost is likely to be the same for each. So this schedule of rates embodied a gross discrimination against large orders.[61]

Because brokers could "profitably execute and clear transactions for investment companies and other large institutional customers at a cost which is only a fraction of the commissions they must charge,"[62] institutional investors and individual brokerage firms adjusted charges with extra services, reciprocal business arrangements, and rebates. In contrast with institutions, most individual investors traded relatively infrequently, were less sensitive to transactions costs, and had little use for such "extras." Also, as noted by Professor George J. Stigler, it is easier to keep a price-cutting deal with a large customer secret from rivals,[63] and size-adjusted transaction costs of such deals are lower.[64] The brokerage cartel became unstable precisely because of the presence of large "buyers" and a sizable number of "sellers,"[65] i.e., institutional investors and brokerage firms, respectively.[66] On the other hand, institutional investors still sought the NYSE

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solicitation fees, finders fees, or dealer distribution fees split with customers; purchases of services and goods at more than a competitive price; and distribution of commissions as allowances in underwritings, fees for research, or retainers. N.Y. Stock Exch., M.F. Educational Circular No. 242 (Aug. 30, 1968); Memorandum from Robert W. Haack, President, N.Y. Stock Exch., to Members and Allied Members, N.Y. Stock Exch. (May 13, 1968) (on file with author).

[59] SPECIAL STUDY, *supra* note 28, pt. 2, at 321.

[60] WELLES, *supra* note 10, chs. 2–3.

[61] 2 ALFRED E. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 196 (1971).

[62] PUBLIC POLICY IMPLICATIONS, *supra* note 31, at 163.

[63] George J. Stigler, *A Theory of Oligopoly*, 72 J. POL. ECON. 44, 47 (1964).

[64] *Id.* at 47 n.8.

[65] *See* EKELUND & TOLLISON, *supra* note 55, at 285 (describing factors that make cartels unstable).

[66] From 1960 to 1975, the number of NYSE member firms varied from 494 to 681. New York Stock Exchange, Inc., Facts & Figures, http://www.nysedata.com/factbook (follow "NYSE and Membership" hyperlink; then follow "Member organizations (1899-1979)" hyperlink) (last visited __).

membership,[67] probably because "extras" were not always desired or did not make up for excessive fixed rates.

Overall, non-price competition, reciprocal arrangements, and rebative practices were destroying the viability of the cartel and eating up the collective profits of the NYSE brokerage firms. Furthermore, these practices attracted the attention of the Exchange and the SEC. According to the NYSE President, "the proliferation of reciprocal practices in the securities industry [were] not only threatening the central marketplace but [were] tending to undermine the entire moral fabric of a significant industry as well."[68] In its turn, the regulatory agency already began directing its attention to practices caused by the existence of the fixed brokerage commissions regime and seeing numerous conflicts of interest already in the late 1950s. For instance, in 1959, Joseph C. Woodle, the director of the SEC's Division of Corporate Regulation, stated that the Commission could "ask Congress for additional legislation to control the way reciprocal business is parceled out. It's clear that any time a fund's investment manager decides to buy or sell for the benefit of a broker, instead of his shareholders, he's violating his fiduciary responsibility."[69]

C. *Inside Information as a Rebate*

Inside information certainly constituted a valuable rebate that brokers could have provided to large customers.[70] In fact, there is evidence that institutional investors desired receiving inside information – probably due to the fact that they possessed adequate financial resources and were sufficiently diversified to make large stakes on the basis of such information and bear the risk of its ultimate price effect. "Inside information, the hint of things to come, becomes a valued commodity to the institutions under constant

[67] *See supra* note 37.
[68] Haack's Remarks, *supra* note 33, at J-2.
[69] *Scandal Troubles Mutual Funds*, *supra* note 57, at 26.
[70] Of course, one must distinguish between true inside information and securities research analyzing publicly available information or aggregating pieces of nonpublic information that are immaterial by themselves. Brokerage firms did provide securities research, but its usefulness was questionable: "[O]nly about 10 percent of Wall Street's research product – perhaps the most important single service other than order execution that the brokerage community provides – was considered sufficiently valuable by those who use it that they would be willing to pay hard cash for it." WELLES, *supra* note 10, at 73 (interpreting the results of the survey in Heidi S. Fiske, *Learning to Live with Negotiated Rates*, INSTITUTIONAL INVESTOR, Mar. 1974, at 45, 48). *See also* R.E. Diefenbach, *How Good Is Institutional Brokerage Research?*, FIN. ANALYSTS J., Jan.-Feb. 1972, at 54, 59 ("We were unable *anywhere* (with one possible exception) to find that quality of excellence so often claimed for institutional research.").

pressure to make productive use of the monies entrusted to them. It is data affirmatively sought; its successful harvesting can alter institutional investment decisions."[71] In their turn, many brokerage firms had access to inside information by the virtue of performing investment banking or advisory services for, being represented on boards of directors of, or even being tipped by issuers.[72] Also, brokers could trade for their customers' accounts on confidential information without even disclosing it to the ultimate beneficiaries: "The discretionary account [is] especially suitable for dealing in information whose value will be exploited rapidly in the market."[73] Of course, brokers would *always* be interested in providing valuable information to their customers, even in the absence of fixed commissions, but the existence of the price restraint greatly magnified this incentive, especially given a relatively low cost of obtaining such information through privileged access to issuers.

Such widespread use of inside information was in fact observed in securities markets, coinciding with the demise of price controls. In 1967, a business periodical noted that the fixed brokerage commissions regime had, in the prior decade, "encouraged the proliferation of more-or-less questionable practices" of brokerage firms, such as supplying preferred customers "with the fruits of 'research,' which all too often means advance word on secondary offering, airline route award, dividend cut or other valuable information."[74] The same publication pointed to "the huge success enjoyed by performance [of] hedge funds, which, thanks to their unparalleled ability to generate commission business, have first call on the best information available to Wall Street."[75] Furthermore, there is evidence that brokers marketed confidential information about upcoming takeovers to institutional investors.[76]

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[71] BAUM & STILES, *supra* note 11, at 36. *See also Stock Market Study: Hearings Before the S. Comm. on Banking and Currency*, 84th Cong. 536–37 (1955) [*hereinafter Stock Market Study Hearings*] (statement of Benjamin Graham, Chairman of the Board, Graham-Newman Corp.) (an official of an institutional investor arguing that the insider trading prohibition did not extend to trading on confidential information obtained by it from management because of the absence of any fiduciary duty to shareholders).
[72] *See infra* Parts III.A and III.B (describing enforcement actions involving such practices of brokers).
[73] MANNE, *supra* note 1, at 73.
[74] *Advice to Brokers*, BARRON'S NAT'L BUS. & FIN. WKLY., Nov. 20, 1967, at 1, 8.
[75] *Heresy on Insiders*, BARRON'S NAT'L BUS. & FIN. WKLY., Oct. 31, 1966, at 1, 1 (reviewing MANNE, *supra* note 1).
[76] Eileen Shanahan, *Insurance Mergers Questioned*, N.Y. TIMES, May 6, 1969, at 57.

In 1966, Professor Henry G. Manne hypothesized that "many directorships [serve] as information-exchange appointments."[77] Indeed, brokerage firms explicitly or implicitly marketed to their customers stocks of companies where representatives of such brokerage firms held directorships, citing informational advantages. The *Special Study* illustrated that trend by citing a broker that "testified that when he receives inside information through a directorship, he transmits this information to his salesmen for the use of the firm's customers and that this is 'one of the reasons why I hope we will be a little more successful than other houses on the street.' "[78] The *Special Study* also observed that some brokerage companies had substantial representation on corporate boards of both listed and OTC companies,[79] and that certainly gave them the access to information. Furthermore, it was recognized that, even when a broker-underwriter was not represented on the corporate board, it still had a sure means of access to inside information.[80]

Just as other rebative practices, this trend also caught the attention of the regulators as interfering with the orderly functioning of securities markets. G. Bradford Cook, the SEC Chairman, attacked the ways of doing business where "inside information is routinely disseminated under the guise of research in exchange for brokerage commissions."[81] Commissioner Philip A. Loomis, Jr. also made a similar observation: "I don't think it encourages fairer markets when institutions salesmen who, having been given information entrusted to their syndicate departments, in confidence, proceed to pass it on to certain institutions, in some cases receiving directed commissions as a reward therefore."[82] Analyzing the attitudes within the regulatory agency, it was observed that "many at the SEC believe some of [brokerage] firms merely use research as a vehicle to solicit inside data that they pass on to large customers."[83]

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[77] MANNE, *supra* note 1, at 65.
[78] SPECIAL STUDY, *supra* note 28, pt. 1, at 437. *See also id.* (noting an instance when another "firm acquired adverse information concerning a company through a directorship, that information was transmitted to customers holding the security").
[79] *Id.* pt. 1, at 429.
[80] *Id.* pt. 1, at 433–34.
[81] G. Bradford Cook, *Chairman Cook on the Evolving Role of the Professional Analyst*, FIN. ANALYSTS J., May-June 1973, at 18, 20.
[82] Phillip A. Loomis, Jr., *Loomis on Inside Information*, FIN. ANALYSTS J., May-June 1972, at 20, 21.
[83] Wayne E. Green, *SEC Sees Court Rulings on 'Insider' Trading Changing Brokers' Method of Operations*, WALL ST. J., Sept. 30, 1968, at 30.

D. *Give-Up System and Its Abolition*

One of the complex rebative arrangements on the NYSE and other securities exchanges was the system of customer-directed give-ups "derived from the customer's ability to direct the member executing a transaction [to pay a part] of the customer's commission payment, in cash, to another member."[84] In the mid-1960s, NYSE members were willing to give-up as much as sixty percent of the full commission.[85] Give-ups were directed in exchange for valuable services not necessarily related to that specific transaction, such as providing securities research and sales of mutual funds.[86] The give-up system was beneficial for large customers that had a use for such services, and it is illustrative that, in 1968, the NYSE members gave-up thirty-eight percent of the $243 million in commissions received from investment companies.[87]

Give-ups certainly represented a surplus above the marginal cost that could be reallocated away from the executing broker, and, not surprisingly, such payments were called "Chinese money."[88] Even the regulators admitted that this practice was a creature of the fixed brokerage commissions regime:

> In the over-the-counter markets where brokerage costs are subject to negotiation, customer-directed give-ups to brokers who perform no necessary function in connection with a transaction long have been recognized as improper and illegal. Mutual fund give-up practices have been tolerated and have spread in the exchange markets *only* because of exchange minimum commission rate schedules, which do not take into account the nature and cost of providing brokerage services to large institutional investors.[89]

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[84] SPECIAL STUDY, *supra* note 28, pt. 2, at 316–17.

[85] PUBLIC POLICY IMPLICATIONS, *supra* note 31, at 170. Give-ups were certainly a phenomenon of the 1960s. "[G]ive-up practices only began to approach their present magnitude within the past six or seven years . . . . In 1961, only 4 to 5 percent of the New York Stock Exchange commissions were given up." Robert W. Haack, President, N.Y. Stock Exch., Statement Regarding the SEC Rate Structure Investigation, [1968-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,590, at 83,247 (Aug. 19, 1968). *See also* INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. 92-64, pt. 4, at 2192 tbl.XIII-19 (1971) [*hereinafter* INSTITUTIONAL INVESTOR STUDY] (documenting that the volume of give-ups on the NYSE directed by investment companies increased from $10.4 million in 1964 to $71.5 million in 1968).

[86] SPECIAL STUDY, *supra* note 28, pt. 2, at 317.

[87] INSTITUTIONAL INVESTOR STUDY, *supra* note 85, pt. 4, at 2183.

[88] Richard W. Jennings, *The New York Stock Exchange and the Commission Rate Struggle*, 53 CAL. L. REV. 1119, 1124 (1965).

[89] PUBLIC POLICY IMPLICATIONS, *supra* note 31, at 17 (footnote omitted).

There is evidence that the give-up system played a big role in disseminating inside information disguised as "research." As one commentator described the transmission of inside information by brokerage companies to their clients, "[e]ven if the tipster firm does not get the order [from the tipped institutional client], it can share the commission through customer-directed give-ups."[90] The existence of give-ups strengthened the organized market for inside information, and a pure exchange of information, unattached to any other service, for hard cash was made more likely.[91]

The SEC had grave doubts about the place of give-ups in the fixed brokerage commissions regime: "Customer-directed give-ups raise questions as to the propriety of the commission rate schedule itself. Assuming that a minimum commission schedule is necessary and appropriate to effective and efficient operation of an exchange, the commission rate structure . . . should not give direct or indirect discriminatory rebates to particular classes of customers."[92] There is little doubt that the original interest of the SEC in the abolition of the give-up system was explained by the regulators' concern for the overall impact of give-ups on the mutual fund industry and the resulting conflicts of interest, and, at least until its *Merrill Lynch* decision in 1968, the SEC did not articulate that give-ups were used as compensation for inside information. Instead, the principal argument was that give-up practices created "distortions and artificial devices in the securities markets [and] interfere[d] with the orderly functioning of the markets, the effective execution of customer orders and the channeling of competitive forces for the benefit of public investors."[93] In 1965, the Commission started its campaign to abolish give-ups, and, by the end of 1968, this change was adopted – not through an official action of the SEC but through individual securities exchanges due to the pressures exerted on them by the regulators.[94]

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[90] *Investment Concerns Review Procedures to Avoid Possible Conflicts of Interest*, WALL ST. J., Aug. 29, 1968, at 24.

[91] The establishment of a market for information about securities can be problematic, but, in this case, it was made possible by repeated interaction and the credibility of privileged access to issuers. *See also* Jack Hirschleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561, 565 (1971) (noting that "it may not be easy for an informed individual to authenticate possession of valuable foreknowledge for resale purposes").

[92] PUBLIC POLICY IMPLICATIONS, *supra* note 31, at 185.

[93] *Id.* at 185–86.

[94] For a description of the SEC actions to abolish give-ups and the analysis of their propriety, see Indep. Broker-Dealers' Trade Ass'n v. SEC, 442 F.2d 132 (D.C. Cir. 1971), *cert. denied*, 404 U.S. 828 (1971). For

The NYSE, the brokerage firms, and other members of the securities industry were hesitant to abolish give-ups. The official position of the Exchange itself was that "[g]ive-ups provide a highly flexible means of compensating various brokerage firms for different constructive services within the framework of a single commission [and] permit[] some firms to concentrate on fundamental research, others to build Floor know-how, and others to focus on local research and local shareholders."[95] A securities industry organization where the NYSE member firms were heavily represented similarly argued that "the trade practice of give-ups has been adopted as the most efficient and equitable means of sharing the compensation for services actually performed."[96] Goldman Sachs stressed the role of give-ups "in compensating for essential services that accrue to the benefit of shareholders."[97] The Investment Banking Association also supported the retention of "both a minimum stock exchange commission rate concept and the division of that commission among bona fide broker-dealers which perform direct or ancillary services for customers."[98]

The give-up system was also defended by institutional investors. One of the leading hedge funds described this practice as a form of compensation "for economic information, investment advice and research work in securities. This is the lifeblood of our operation; we could not continue in business without it."[99] This hedge fund also pointed out that "[n]o 'give-ups' [were] issued for the sale of shares or interests in our

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another description of the SEC's efforts to abolish give-ups, see SELIGMAN, *supra* note 10, at 398–405. Yet, the prohibition of give-ups had not completely stopped commission-splitting practices of the brokerage community. For instance, institutional investors started sending large orders to block positioners via "friendly" brokers that performed various services for such investors in exchange for the difference between the public and intermember commission rates. James L. Hamilton, *Deregulation in the Securities Brokerage Industry*, *in* DEREGULATION: APPRAISAL BEFORE THE FACT 75, 86 (Thomas G. Gies & Werner Sichel eds., 1982).

95 Letter from Robert W. Haack, President, N.Y. Stock Exch., to Orval L. DuBois, Sec'y, Sec. and Exch. Comm'n 6 (Mar. 21, 1968) (on file with author). *See also id.* at 11 ("[G]ive-ups are a most efficient and economical means of enabling substantial investors to meet their obligations, as they see them, to many brokers.").

96 Ass'n of Stock Exch. Firms, Comments on SEC Proposed Rule 10b-10 and NYSE Proposal on Commission Rates, Fed. Sec. L. Rep. (CCH), extra ed. no. 198, May 3, 1968, at 38 (n.d.).

97 Letter from Goldman, Sachs & Co. to Orval L. DuBois, Sec'y, Sec. and Exch. Comm'n (Mar. 29, 1968), http://www.sechistorical.org/collection/papers/1960/1968_0329_GoldmanSachs_10b10.pdf (last visited ___).

98 Letter from Francis B. Schanck, President, Inv. Bankers Ass'n of America, to Manuel F. Cohen, Chairman, Sec. and Exch. Comm'n (Aug. 16, 1968), http://www.sechistorical.org/collection/papers/1960/1968_0816_Schanck.pdf (last visited ___).

99 Letter from [name redacted] to Special Comm. on Member Firm Costs and Revenues, N.Y. Stock Exch. 2 (Mar. 3, 1967) (on file with author).

fund."[100] This comment certainly illustrates the role of the give-up system as a method of distributing valuable information from brokerage firms to sophisticated hedge funds. One of the largest institutional investors was also skeptical about the abolition of give-ups: "[R]esearch services rendered by brokers are unquestionably beneficial to the funds and the fund shareholders. . . . [I]t is traditional and appropriate to compensate brokers for such services from portfolio brokerage."[101] Another leading institutional investor similarly commented that the use of give-ups "to reward a broker who expected to earn commissions on transactions placed through him because of a good research idea . . . is entirely proper."[102] Another institutional investor did not condemn the give-up system as such[103] but pointed to a preferred alternative where "the excess cash [would be] available directly to the customer in the form of lower commissions rather than in the form of the privilege of deciding to whom within a certain limited class, it should be given."[104]

It is clear that the give-up system was a creature of the fixed brokerage commissions regime and that it contributed to the functioning of the market for inside information involving brokerage firms and large investors. But as questionable give-up practices came under the scrutiny of the SEC, both the brokerage industry and the institutional investor community opposed the abolition of the give-up system. It might seem surprising that the NYSE had reservations about the elimination of an implicit discount, but it might be explained by the existence of rebative practices on other securities exchanges.[105]

[100] *Id.*
[101] Letter from Robert M. Loeffler, Vice President – Law, Investors Diversified Servs., Inc., to Sec. and Exch. Comm'n (Mar. 29, 1968), http://www.sechistorical.org/collection/papers/1960/1968_0329_IDS.pdf (last visited ___).
[102] Letter from D. George Sullivan, Vice President, Fidelity Mgmt. & Research Co., to Sec. and Exch. Comm'n (Mar. 29, 1968), http://www.sechistorical.org/collection/papers/1960/1968_0329_Fidelity.pdf (last visited ___).
[103] Frank J. Hoenmeyer, Executive Vice President, Prudential Ins. Co. of America, to Orval L. DuBois, Sec'y, Sec. and Exch. Comm'n (Mar. 29, 1968), http://www.sechistorical.org/collection/papers/1960/1968_0329_Prudential.pdf.
[104] *Id.*
[105] *See* SPECIAL COMM. ON MEMBER FIRM COSTS AND REVENUES, N.Y. STOCK EXCH., INTERIM REPORT ON VOLUME DISCOUNT, CUSTOMER-DIRECTED GIVE-UPS AND NONMEMBER BROKER DISCOUNT (1968), *reproduced in* N.Y. Stock Exch., Minutes of the Board of Governors, pt. 10, at 1028 (June 27, 1968) ("[The practice of give-ups] weakens the economic basis of the minimum commission structure itself [but] cannot be effectively abolished by the unilateral action of one national securities exchange. To be effective, the action taken must apply uniformly to all markets.").

II. *Cady, Roberts* Decision: Its Background, Significance, and Connection to the Fixed Brokerage Commissions Regime

This Part examines the background and significance of the *Cady, Roberts* decision and asserts that the facts suggest a clear connection between the use of inside information and existence of the fixed brokerage commissions regime. Section II.A examines the facts of the decision and argues that there is strong evidence that the use of inside information by the brokerage firm was due to competitive pressures caused by the price restraints. Section II.B analyzes the subsequent actions of the NYSE and shows that the Exchange was not greatly interested in outlawing the use of inside information by its members. Section II.C looks at the initial reaction of the SEC to the *Cady, Roberts* affair and argues that the actions of the regulatory agency were explained by its concern over directorships held by brokerage firms. Section II.D shows that the *Cady, Roberts* decision was a major milestone for the regulation of insider trading.

A. *Facts and the Connection to the Fixed Brokerage Commissions Regime*

On November 25, 1959, J. Cheever Cowdin, a member of the board of directors of the Curtiss-Wright Corporation and a registered representative of Cady, Roberts & Co., a NYSE brokerage firm, informed Robert M. Gintel, a partner in the same brokerage firm, that the board had decided to cut the dividend from 62.5 to 37.5 cents despite the favorable publicity about the new internal combustion engine developed by Curtiss-Wright.[106] There could be some dispute whether this information leak was prearranged, but the phone call from Cowdin to the order clerk who conveyed the information to Gintel occurred during a brief recess of the board meeting shortly after the dividend decision was made. While in possession of this information and before it appeared on the Dow Jones ticker tape, Gintel made a series of stock dispositions and short sales of the Curtiss-Wright common stock. Interestingly, Gintel had been liquidating some of the

[106] The description of the underlying facts in the *Cady, Roberts* affair in this section is based on Dept. of Member Firms, N.Y. Stock Exch., Materials of the Censure of Robert M. Gintel (1959-60). These materials are especially valuable because the SEC materials on the administrative proceedings against Cady, Roberts & Co. and Robert M. Gintel were destroyed, in accordance with the agency's retention policy for documents pertaining to broker-dealer administrative proceedings, after twenty five years. *See* Letter from Mark P. Siford, FOIA/Privacy Act Research Specialist, Office of Filings and Info. Servs., Sec. and Exch. Comm'n, to author (July 18, 2006) (on file with author). Thus, materials pertaining to other important administrative proceedings discussed in this Article have also been destroyed.

Curtiss-Wright holdings at his disposal earlier that morning before receiving such information. Cowdin later claimed that he thought that the dividend news had already been disseminated at the time of his phone call and that he only wanted to inquire about the impact of the announcement on the stock price of Curtiss-Wright, but it is also questionable. The phone call made by Cowdin occurred only approximately ten minutes after the dividend decision was made, and an expectation of a wide dissemination of this information at that time was probably unreasonable.

One of the most important facts in the *Cady, Roberts* affair is the presence of a large mutual fund that invested heavily in Curtiss-Wright. The representative of that mutual fund – also an aerospace industry analyst – was in the office of Cady, Roberts & Co. and in contact with Gintel when the latter acquired the information about the dividend reduction. Furthermore, that mutual fund representative had initially contacted Cady, Roberts & Co. specifically because he was trying to get "in touch" with the management of Curtiss-Wright and thought that it would be possible via the directorship held by Cowdin. In fact, Gintel sold 2,000 shares held by this mutual fund after Cowdin's phone call,[107] but he later argued that the order was received *before* he was even informed about the dividend cut. Yet, the circumstances strongly suggest that Gintel in fact conveyed the information – or, at least, gave a sly wink – to the representative of the fund and triggered the transaction.[108] Furthermore, a substantial portion of the short sales executed by Gintel were made on the joint account of individuals affiliated with – and recommended to Gintel by – the representative of the mutual fund.[109]

Gintel denied that getting brokerage commissions had induced him to use inside information for the benefit of his clients. Yet, there is evidence that Gintel was pressured to provide "research," often a codeword for inside information,[110] to institutional

[107] The avoided loss was approximately four dollars per share.

[108] Another important piece of information is that the institutional investor in question had sold approximately 10,000 Curtiss-Wright shares around the dividend-reduction announcement, i.e., through other brokerage firms besides Cady, Roberts & Co. It is quite likely that some of these orders were executed before the announcement, although the available information does not answer this question. If this is an accurate guess of what had happened, it would seem even clearer that the order executed though Cady, Roberts & Co. was a reward for conveying this crucial piece of information, although, generally, there might be other possible reasons for splitting a large order among different brokers.

[109] However, it appears that most short sales executed by Gintel were made on the accounts of customers not connected with any institutional investor.

[110] *See Advice to Brokers, supra* note 74, at 8.

investors *precisely* because Cady, Roberts & Co. – unlike its many competitors – did not sell shares of mutual funds to obtain brokerage business. Thus, the facts of *Cady, Roberts* clearly point to the strains of the fixed brokerage commissions regime and the competitive pressure on brokerage firms to transmit inside information to institutional investors. Another exposed problem was the representation of brokers on corporate boards, as Cady, Roberts & Co. did not have a formal policy on the issues pertaining to its employees serving on boards of issuers or any internal informational barriers.

B. *Reaction of the New York Stock Exchange*

The NYSE did not classify Gintel's activities as a rebative practice, although it took that matter very seriously during that time period.[111] The Exchange was more concerned with the role of the Curtiss-Wright Corporation in the delay of the dividend reduction announcement.[112] The Department of Member Firms, the NYSE's enforcement arm, even cautioned against the creation of a broad precedent aimed at insider trading:

> [T]he fact that the situation involves "inside information" might result in improper interpretation on the part of both member firms and the public that the Exchange has established a principle that the use at any time of information which had not been given general publicity is, per se, an offense against the public interest constituting conduct inconsistent with just and equitable principles of trade or act detrimental to the interest or welfare of the Exchange when no such conclusion is intended.[113]

In other words, the Exchange did not feel particularly threatened or disturbed by then-existing insider trading practices in the brokerage community, and, furthermore, Cowdin and Gintel broke no clear legal or industry norm. This was consistent with the NYSE's historic policy of occasional criticism and non-existent direct regulation of trading by

[111] Some kickback schemes involving brokerage firms were even adjudicated on the level of the NYSE's Board of Governors. *See, e.g.*, N.Y. Stock Exch., Minutes of the Board of Governors, pt. 6, at 398–416 (Nov. 18, 1959) (making payments to non-member customers to rebate commissions); *id.* pt. 6, at 334–38 (July 2, 1959) (nominally employing a registered representative in exchange for commission business).
[112] *See* Letter from Phillip L. West, Vice President, N.Y. Stock Exch., to Roy T. Hurley, Chairman, Bd. of Dirs., Curtiss-Wright Corp. 3 (Feb. 10, 1960) (on file with author) ("The delay in the release of the dividend news [warrants attention], particularly in the light of the lengthy discussion between the Exchange and your Corporation some years ago in connection with the delay in the announcement of the deferred dividend action on the class A Stock.").
[113] Memorandum from Dep. of Member Firms, N.Y. Stock Exch. 7–8 (Feb. 4, 1960) (on file with author).

corporate insiders,[114] restrictions on trading by NYSE employees,[115] and virtually no limitations on the use of inside information about listed companies by NYSE members. The Exchange had traditionally preferred to focus on mandating accurate and prompt corporate disclosure[116] rather than to regulate trading by corporate insiders of listed companies. It was a sensible policy for the Exchange due to its lack of enforcement resources and jurisdiction over individual corporate insiders, and, most likely, it had no direct economic interest in prohibiting insider trading.

The NYSE censured Gintel for "a short sale of 500 shares for a completely new account [for which he] had never before done business . . . and had no authorization for entering such an order" and imposed a fine of $3,000.[117] The Exchange seemed to pay some lip service to the issue of insider trading: "In view of . . . the particular circumstances under which you received the dividend information, you should have

[114] In 1875, a special committee of the Exchange had expressed its disapproval of trading on confidential information by corporate insiders, the situation described as when "a favored few" use confidential information "to the prejudice of the many." Form Letter from Brayton Ives, Salem T. Russell & Donald MacKay, N.Y. Stock Exch., to listed companies (Oct. 11, 1875) (on file with author). "This unjustifiable action has done more than anything else to bring railroads, especially, into disrepute. 'Speculating Directors' have become so odious that we feel that honest officers owe it to themselves as well as to the public to correct this evil state of affairs . . . ." *Id. See also* Richard Whitney, President, N.Y. Stock Exch., Statement Made to the Governing Committee and the Membership in Regard to the Investigation of Stock Exchange Practices by the Banking and Currency Committee of the United States Senate 28–29 (Aug. 24, 1932) (on file with author) ("The Exchange, of course, has no control of corporate officers but it is unalterably opposed to the misuse of confidential information."). An interesting historical episode is that the NYSE and the securities industry as a whole were quite skeptical about the provisions of the Securities Exchange Act of 1934 that regulated trading by corporate insiders. For instance, in 1939, the conference of leading securities exchanges – including the NYSE – argued for the repeal of Section 16(b) as detrimental to market liquidity and concluded that any legislation "designed to prevent the unfair use of inside information and to afford appropriate remedies to injured parties . . . is impracticable in the light of past experience." *Text of Exchanges' Proposals to SEC*, WALL ST. J., Mar. 15, 1939, at 11.

[115] A likely early example of that policy is the NYSE's prohibition of trading by "any telephone clerk employed within the Exchange." N.Y. Stock Exch., Minutes of the Governing Committee, pt. 7, at 362–63 (Nov. 27, 1917). It is not inconceivable that this restriction might have been at least partially explained by the fact that telephone clerks played a role in transmitting orders to the floor of the Exchange and had access to price-moving news and that their trading might have decreased the profits of NYSE members themselves. *See also Stock Market Study Hearings*, *supra* note 71, at 57 (statement of G. Keith Funston, President, New York Stock Exchange) (stating that "[n]o exchange employee can take advantage of any information that he secured as an exchange employee and purchase stock based on that information" and describing the procedures for reporting stock transactions for NYSE employees).

[116] *See, e.g.*, ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 297 (1932) (stating that the NYSE's listing standards were leading "towards an increasingly full and increasingly prompt disclosure"); WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET 210 (1927) (describing the NYSE as "the leading influence in the promotion of adequate corporate disclosure").

[117] Minutes of Censure of Robert M. Gintel before the Advisory Committee of the Board of Governors of the New York Stock Exchange 1–2 (Feb. 24, 1960) (on file with author). The full Board was briefed about the censure shortly thereafter. N.Y. Stock Exch., Minutes of the Board of Governors, pt. 7, at 474 (Feb. 25, 1960).

raised a question in your own mind of the propriety of using that information before it became public property."[118] But, overall, the NYSE "did not contemplate any publicity" of the *Cady, Roberts* affair[119] and preferred to take a rather minor enforcement action,[120] probably because it was pushed "to do something" by the regulators. In fact, there is evidence that the Exchange was not very enthusiastic about the subsequent administrative adjudication issued by the Commission. According to SEC Chairman William L. Cary, NYSE President Keith Funston objected to the regulatory agency's decision, "characterizing [it] as an unwarranted step toward raising standards to an unrealistic level."[121]

On the other hand, the NYSE did not oppose the *Cady, Roberts* decision publicly and even issued a pronouncement that the SEC's policy did not question "the ordinary practices of analysts and brokers seeking and using corporate information of type company officials would give to any one [sic] having a legitimate interest in the company."[122] Furthermore, the NYSE declared that

> [a]ny director of a corporation who is a partner, officer or employee of a member organization should recognize that his first responsibility in this area is to the corporation on whose Board he serves [and] meticulously avoid any disclosure of inside information to his partners, employees of the firm, his customers or his research or trading departments.[123]

Yet, given the competitive pressure to use inside information, this stance of the Exchange on the limitations on the use of such information and the creation of internal informational barriers had weak foundations to be followed by its member firms.

C. *Initial Reaction of the Securities and Exchange Commission*

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[118] *Id.* at 2.
[119] Memorandum from J.H. Schwieger, Vice President, N.Y. Stock Exch. 1 (Feb. 11, 1960) (on file with author).
[120] The fine imposed on Gintel was not intended to be punitive. In fact, the amount of the fine was slightly *less* than the trading profits made on the account of his wife on the basis of the dividend-reduction information. *See* Memorandum from Dep. of Member Firms, N.Y. Stock Exch., to Advisory Comm., Bd. of Governors, N.Y. Stock. Exch. 3 (Feb. 8, 1960) (on file with author). On the other hand, Cowdin's registration with the NYSE was withdrawn. Extract from Minutes of the Department of Member Firms Staff Meeting, N.Y. Stock Exch. 1 (Feb. 25, 1960) (on file with author).
[121] WILLIAM L. CARY, POLITICS AND THE REGULATORY AGENCIES 84 (1967).
[122] N.Y. Stock Exch., Dept. of Member Firms, M.F. Educational Circular No. 151 (Dec. 15, 1961).
[123] N.Y. Stock Exch., Dept. of Member Firms, M.F. Educational Circular No. 162 (June 22, 1962).

The SEC reacted promptly to the unusual trading activities in the stock of Curtiss-Wright by launching its own investigation. John H. Schwieger, the NYSE's Vice President, described his conversation with Paul Windels, Regional Administrator of the SEC's New York Office, regarding the regulators' likely motivations to intervene, as follows:

> Mr. Windels said that [Gintel] had been moving primarily on the backing of Rittmaster, who formerly was [sic] associated with Wolfson. According to Mr. Windels, some of Gintel's directorships have been the result of Rittmaster's direction. Mr. Windels said that he has the personal feeling that the transmission of dividend information from Cowdin to Gintel was not merely coincidental.[124]

In other words, the regulatory agency was concerned with Gintel's ties to Louis Wolfson, the famous takeover artist, and his associate Alexander Rittmaster,[125] although neither of these two individuals appeared to be involved in trading on inside information in the stock of Curtiss-Wright. Furthermore, the regulators paid attention to the fact that Gintel himself was a director of another company controlled by the Wolfson-Rittmaster group that was considering a merger with Curtiss-Wright,[126] and they probably had reservations about the expansion of the Wolfson empire. Furthermore, the SEC had previously taken enforcement actions against Wolfson and corporate directors affiliated with him.[127] It is clear that the Commission was tackling the issue of directorships held by representatives of the brokerage industry. Attaching a great weight to the *Cady, Roberts* incident, the SEC's New York Office prepared a report to the Commission, drafted by William D. Moran, SEC's Assistant Regional Administrator, recommending to "institute revocation

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[124] Memorandum from J.H. Schwieger, *supra* note 119, at 1.

[125] For some background information on Louis Wolfson and his "chief financial aide" Alexander Rittmaster, see DIANA B. HENRIQUES, THE WHITE SHARKS OF WALL STREET: THOMAS MELLON EVANS AND THE ORIGINAL CORPORATE RAIDERS 74–80, 151–57 (2000). *See also* Robert E. Bedingfield, *Personality: Aide and Commander as Well*, N.Y. TIMES, Oct. 6, 1957, at 17 (describing the alliance of Wolfson and Rittmaster); *Alexander Rittmaster Resigns as a Director of Merritt-Chapman*, WALL ST. J., Nov. 10, 1964, at 15 (describing Rittmaster's resignation that probably ended his active collaboration with Wolfson).

[126] Memorandum from J.H. Schwieger, Vice President, N.Y. Stock Exch. 3 (Jan. 7, 1960) (on file with author).

[127] *See* Litigation Release No. 1315, 1958 SEC LEXIS 895 (Aug. 1, 1958) (the SEC securing a permanent injunction enjoining Wolfson and his associates from violating antifraud and anti-manipulation regulation – including Rule X-10B-5 – by trading in securities of American Motors Corp.). Previously, Wolfson placed two of his associates on the company's board of directors. *The Wolfson Story Begins a New Chapter; Climax or Anticlimax?*, WALL ST. J., Aug. 1, 1958, at 1. The American Motors incident was described as "the Wolfson-Windels clash," referring to the fact that the SEC team was led by the same Paul Windels. *Id.*

proceedings against Cady, Roberts & Co. under Section 10-B-5 of the 1934 Act based on the conduct of Gintel and Cowdin . . . the first such proceeding under 10-B-5 . . . based on the claim that Gintel was in possession of inside information."[128]

D. *Regulatory Impetus of the* Cady, Roberts *Decision*

The importance of the SEC's administrative adjudication in the matter of Cady, Roberts & Co. authored by Chairman William L. Cary[129] can hardly be overestimated. In the words of Professor Donald C. Langevoort, it "built the foundation on which the modern law of insider trading rests."[130] Chairman Cary later observed that "the Commission, for the first time, said that the duty of insider disclosure or abstinence applied in an exchange market and that it was a fraudulent practice to sell a security while in possession of inside information in a faceless transaction as well as face-to-face."[131] The SEC's decision itself noted that "[i]t would be anomalous indeed if the protection

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[128] Memorandum from J.H. Schwieger, *supra* note 126, at 1. SEC Chairman William L. Cary is usually credited for the outcome of *Cady, Roberts*, and, certainly, his role in pushing the decision though cannot be ignored. *See, e.g.*, Louis Loss, *Comment*, 63 COLUM L. REV. 861, 861 (1963) ("[I]f Professor Cary does nothing else at the SEC he has earned his pay in *Cady, Roberts & Co.* I view it as a landmark in the law.") (footnote omitted). But this memorandum makes very clear that the SEC's enforcement machine was in motion and the decision to create the precedent under Rule 10b-5 reaching the use of inside information in impersonal markets had been taken in his absence. After all, Chairman Cary took office only on March 27, 1961. U.S. Securities and Exchange Commission, Concise Directory, http://www.sec.gov/about/concise.shtml#history (last visited __). Furthermore, the discussion of insider trading in the treatise co-authored by Cary, RALPH J. BAKER & WILLIAM L. CARY, CASES AND MATERIALS ON CORPORATIONS 553–90 (3d unabr. ed. 1958), did not unambiguously suggest the future outcome of the *Cady, Roberts* decision.

[129] Chairman Cary later acknowledged that the "ghost writer" of the *Cady, Roberts* decision was his assistant Arthur Fleischer, Jr. Symposium, *Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1009 (1966).

[130] Langevoort, *supra* note 5, at 1319.

[131] William L. Cary, *The Direction of Management Responsibility*, 18 BUS. LAW. 29, 32 (1962). *Also compare* U.S. SEC. AND EXCH. COMM'N, PROPOSAL TO SAFEGUARD INVESTORS IN UNREGISTERED SECURITIES, H.R. DOC. NO. 79-672, at 9 (1946) [*hereinafter* PROPOSAL TO SAFEGUARD INVESTORS] (stating that "many of the cases in which managements have made unfair use of inside information may not be outright frauds in the legal sense; they maybe grossly unfair and unjustified without constituting violations of law"), *with Study of Securities and Exchange Commission: Hearings on Powers, Duties, and Functions of Securities and Exchange Commission Before a Subcomm. of the H. Comm. on Interstate and Foreign Commerce*, 82d Cong. pt. 1, at 725–26 (1952) [*hereinafter Study of Securities and Exchange Commission Hearings*] (statement of Peter T. Byrne, Regional Administrator, New York Office, Securities and Exchange Commission) (arguing that the SEC's interpretation of Rule X-10B-5 implies that "an insider cannot take advantage of a stockholder . . . in connection with the purchase from him or the sale to him of the company's stock where he has information not known to that man on the other side of the transaction because of his fiduciary obligation to disclose it to him" but does not cover transactions by tippees).

afforded by the anti-fraud provisions were withdrawn from transactions effected on exchanges, primary markets for securities transactions."[132]

The obligation to disclose information or abstain from its use was said to be based on two broadly-defined principles: "the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit [and] the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[133] The *Cady, Roberts* decision also classified information by drawing a line between information that has "direct effect on the market value of securities" obtained as a result of privileged access to the issuer and information "arrived at as a result of perceptive analysis of generally known facts"[134]

The SEC's use of Rule 10b-5 in *Cady, Roberts*, in contrast to a much weaker and narrower section 16 of the Securities Exchange Act,[135] expanded the scope of insider trading regulation and emphasized the role of administrative adjudications to create regulation.[136] The immediate outcome of the decision was a wake-up call for brokers and other securities market professionals, sitting on corporate boards: "The subjection of the banker to vague and ill-defined risks because of the relationship will result in, and has already caused, many competent persons to refuse to accept directorships."[137] Furthermore, discussing the fact that institutional investors were often fed inside information by brokers, the commentators noted that "the wolf is certainly at the door for

[132] Cady, Roberts & Co., 40 S.E.C. 907, 914 (1961).
[133] *Id.* at 912. *See also id.* ("In considering these elements under the broad language of the anti--fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications.").
[134] *Id.* at 915.
[135] The original section 16 of the Securities Exchange Act of 1934, Pub. L. No. 290, 48 Stat. 881, 896-97, was substantially changed only in 1964, with its extension to the OTC markets and the creation of the exemption for market makers from the "short-swing" profit provision. Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 8, 78 Stat. 565, 579.
[136] For the analysis of the administrative-law aspects of *Cady, Roberts*, see CARY, *supra* note 121, at 82–84; Manuel F. Cohen & Joel J. Rabin, *Broker Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROBS. 691, 715–16 (1964); Henry G. Manne, *Insider Trading and the Administrative Process*, 35 GEO. WASH. L. REV. 473, 480–83, 504–09 (1967). *See also* Cohen & Rabin, *supra* (comparing general rule-making and case-by-case adjudication by the SEC as alternative means of creating regulatory norms).
[137] Daum & Phillips, *supra* note 5, at 959.

the institutions in the *Cady, Roberts* case."[138] Thus, the decision had a major significance for the networks of information-transmission within the securities industry.

III. Enforcement Strategy of the SEC and the Link Between Fixed Brokerage Commissions Regime and the Use of Inside Information

This Part argues that the overall enforcement program of the Securities and Exchange Commission that led to insider trading regulation and the creation of Chinese Walls was strongly influenced by the existence of the fixed brokerage commissions regime. Section III.A applies this argument to SEC's actions involving the use of inside information for the benefit of brokers' clients. Section III.B extends the same argument to actions involving the creation of Chinese Walls within financial intermediaries. Section III.C asserts that the regulatory agency's enforcement program dealing with insider trading and Chinese Walls could be understood as the interaction of the consequences of the fixed brokerage commissions regime and other related factors.

A. *SEC's Enforcement and the Use of Inside Information by Brokerage Firms for the Benefit of Their Clients*

As it was indicated earlier, *Cady, Roberts* most likely involved an instance of selective disclosure of information by a broker to an institutional client or, at a minimum, the use of such information for the client's benefit. Similar enforcement actions of the SEC continued well into the future. This demonstrates that the early development of insider trading regulation was heavily influenced by the fact that inside information served as a rebate for brokerage business.

One important enforcement action concerning insider trading as a rebative practice was directed against Frederic S. Mates. One of the charges was that Mates Financial Services, an entity controlled by Mates, "allocated the execution of securities transactions on behalf of MFS advisory clients to brokerage firms which gave MFS and Mates rebates [which] took the form of payments purportedly for an investment advisory publication."[139] It was also alleged that, in 1968, a director of the AMEX-listed Ramer

[138] Baum & Stiles, *supra* note 11, at 39.
[139] Mates Fin. Servs., 44 S.E.C. 246, 256 (1970).

Industries and a partner of a brokerage firm holding both the NYSE and AMEX memberships, supplied Mates with inside information about Ramner in exchange for large orders in that stock executed through his firm: "Mates placed orders with the director for the purchase of a total of 27,000 shares of Ramer stock on behalf of the Fund [controlled by Mates] and two other mutual funds. Prior to this time, none of the three funds had ever transacted any business with the Ramer director."[140] Most certainly, it was a hidden rebate on commissions, as the AMEX had a minimum commissions schedule similar to the NYSE's. Additionally, the brokerage firm did not subscribe to the MFS's advisory service and hence could not rebate money that way.[141]

Another illustration how inside information served as a currency for brokerage commissions is the SEC's civil suit against Glen Alden Corporation.[142] In 1968, the representatives of the NYSE-listed Glen Alden disclosed confidential information about the company during special meetings with the representatives of Investors Diversified Services, the investment manager of Investors Variable Payment Fund and Putman Growth Fund.[143] The meetings were arranged by Carter, Berlind & Weill, a NYSE member.[144] According to the SEC, Glen Alden provided "sales, earnings and cash flow projections for Glen Alden and each of its divisions for the years 1968 to 1972, projected acquisitions and other material information concerning the affairs of Glen Alden and its related companies."[145] In other words, the SEC attacked the practice of selective disclosure arranged by a broker-dealer in exchange for a cut from its clients' transactions on inside information.

Another SEC enforcement action involving the use of inside information by a broker-dealer was directed against Butcher & Sherrerd, a NYSE member, for its 1970 transactions in the NYSE-listed Penn Central on behalf of its preferred clients as well as

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[140] *Id.* at 258.
[141] Dept. of Member Firms, N.Y. Stock Exch., Materials of the Investigation in the Matter of Frederic S. Mates (1969).
[142] SEC v. Glen Alden Corp., 68 Civil Action No. 3203, 1968 U.S. Dist. LEXIS 12081 (S.D.N.Y. Aug. 7, 1968).
[143] *Id.* at *2.
[144] *Id.*
[145] *Id.* at *3. Later it was also alleged that Carter, Berlind & Weill served as an intermediary and an executing broker between Glen Alden and Investors Diversified Services in an attempt to assemble "friendly" shares for a takeover of another company by Glen Alden. Penn Mart Realty Co. v. Becker, 300 F. Supp. 731, 733–34 (1969).

the insiders of the brokerage firm itself.[146] Butcher & Sherrerd was one of the members of the underwriting syndicate assembled to raise capital for a debentures offering for one of the Penn Central's subsidiaries.[147] The fact that the securities offering in question ultimately failed was a clear sign of financial distress not communicated to the market: "[T]he month's biggest news – discovery that the debentures could not be sold – was never announced."[148] Apparently, the fact that Butcher & Sherrard had resigned its directorships in all publicly-held companies – including the Penn Central directorship – in 1968[149] did not stop the flow and use of inside information.

Another similar enforcement action was directed against Bausch & Lomb, a NYSE-listed company, and Faulkner, Dawkins & Sullivan, a NYSE member firm.[150] The SEC complaint alleged that, in 1972, the chairman of Bausch & Lomb conveyed inside information regarding its sales and expected earnings to a securities analyst at the brokerage firm, and, as a result, dispositions of stock and short sales were made on behalf of institutional clients.[151] But the courts refused to impose liability, primarily because neither materiality of such information nor scienter were proved.[152]

Yet another SEC enforcement action involving selective disclosure made by an issuer to a broker-dealer was directed against the NYSE-listed Liggett & Myers. The regulatory agency imposed on the company the duty to "implement, and hereafter supervise its employees' compliance with a written statement of policy with respect to disclosure of material non--public information, which contains procedures to prevent disclosure of material non--public information in violation of the federal securities laws."[153] The facts of the controversy indeed indicate that the issuer tipped selected

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[146] Butcher & Sherrerd, Exchange Act Release No. 9894, 1972 SEC LEXIS 849 (Dec. 11, 1972).
[147] Fred L. Zimmerman, *How Broker with Links to Penn Central Sold Shares Before Collapse*, WALL ST. J., Oct. 22, 1970, at 1.
[148] *Id.*
[149] *Broker Firm's Partners Quitting Boards of Public Firms to Bar Interest Conflict*, WALL ST. J., Oct. 1, 1968, at 6.
[150] Litigation Release No. 5918, 1973 SEC LEXIS 2861, at *1 (June 4, 1973).
[151] *Id.* For a more detailed description of the events, see *Bausch & Lomb, Officer, Brokers Charged by SEC,* WALL ST. J., June 5, 1973, at 2.
[152] SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976), *aff'd*, 565 F.2d 8 (2d Cir. 1977).
[153] SEC v. Liggett & Myers, Inc., 73 Civil 2796, 1973 U.S. Dist. LEXIS 11401, at *3 (S.D.N.Y. Oct. 24, 1973).

brokers about important corporate developments, and at least one of them traded on behalf of a large institutional investor.[154]

The analyzed actions of the SEC clearly indicate that the regulators were going after the use of confidential information obtained by broker-dealers via their board representation, performance of financial services, or tips provided by issuers themselves. Without any doubt, the need to use such information for the benefit of large clients was strongly reinforced by the existence of the fixed brokerage commissions regime.[155]

B. *SEC's Enforcement and the Creation of Chinese Walls Within Financial Intermediaries*

Enforcement actions of the SEC that encouraged the creation of Chinese Walls followed the same pattern: factual circumstances indicate that inside information served as a rebate for brokerage business and was transmitted within financial intermediaries largely due to competitive pressures imposed by and the means created by the fixed brokerage commissions regime.

The pivotal regulatory action that led to the widespread use of Chinese Walls within financial intermediaries was the SEC's *Merrill Lynch* decision. Merrill Lynch, one of the largest brokerage firms, was the managing underwriter of the NYSE-listed Douglas Aircraft's convertible subordinated debentures.[156] As an underwriter, Merrill Lynch learned that Douglas was expecting little or no profit in the 1966 fiscal year and had reduced its earnings projections for the upcoming year.[157] Consequently, the institutional sales personnel at Merrill Lynch, tipped by the underwriting personnel, shared this information with preferred clients.[158] Several of these clients sold the Douglas stock held

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[154] Elkind v. Liggett & Myers, Inc., 66 F.R.D. 36, 38–39 (S.D.N.Y. 1975).
[155] A limited number of cases involved the use of inside information by broker-dealers for the benefit of their clients in markets not subject to the fixed brokerage commissions regime. *See, e.g.*, SEC v. F.L. Salomon & Co., et al., Litigation Release No. 6056, 1973 SEC LEXIS 2534 (Sept. 13, 1973) (a lawsuit brought by the SEC against a large group of defendants, mostly broker-dealers, investment advisors, mutual funds, and their employees, for their involvement in the use of inside information about an OTC stock in 1971); Van Alstyne, Noel & Co., 43 S.E.C. 1980 (1969) (an SEC enforcement action against a broker-dealer for its use of inside information about an OTC-traded company). *See also* Blythe & Co., 43 S.E.C. 1037 (1969) (an SEC enforcement action against a broker-dealer for trading on its account on inside information pertaining to new issues of government securities from January 1964 to November 1967).
[156] Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 935 (1968).
[157] *Id.*
[158] *Id.*

and effected short sales of more than 190,000 shares on the NYSE.[159] In return, these clients executed such transactions through Merrill Lynch or directed their executing brokers to make give-up payments to Merrill Lynch.[160]

There is little doubt that this episode was a consequence of the fixed brokerage commissions regime, as Merrill Lynch was not just rewarded with commission business but also with give-ups, confirming that the give-up system, the creature of price restraints, served as a market for inside information. In the eyes of the SEC attorneys, giving inside tips in exchange for brokerage dollars was "a relatively common practice,"[161] and the Commission's actions were seen as "as a further effort on the part of the regulatory agency to attack 'give-ups,' forced commission-splitting in return for service, such as tips on inside information."[162] Furthermore, this episode illustrated the importance of non-price competition in the brokerage industry. As a contemporary commentator concluded, "Merrill Lynch undoubtedly believed that competition required it to selectively pass on the information it had about Douglas' earnings."[163]

The facts of the *Merrill Lynch* decision were not related to board representation of financial institutions,[164] and, in fact, the regulators endorsed a new prophylactic device: "In determining to accept the offers of settlement . . . [the SEC had] taken into consideration [Merrill Lynch's] undertaking to adopt, implement, and ensure compliance with, revised procedures to provide more effective protection against disclosure of confidential information . . . ."[165] Merrill Lynch's Statement of Policy put strict limitations on internal flows of "[m]aterial information obtained from a corporation by

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[159] *Id.*

[160] *Id.* For a more detailed description of the events, the identities of individual tippees – which included leading hedge funds, investment partnerships, and mutual fund advisors – and the amounts of give-up payments, see Investors Mgmt. Co., Hearing Examiner's Initial Decision, 1970 SEC LEXIS 3042 (June 26, 1970). *See also* City Assocs., Exchange Act Release No. 8509, Investment Advisors Act Release No. 242, 1969 SEC LEXIS 228 (Jan. 31, 1969) (the SEC accepting an offer of settlement of another institutional investor tipped by Merrill Lynch in exchange for give-up payments).

[161] Terry Robarts, *S.E.C. Accusation Jars Wall Street*, N.Y. TIMES, Aug. 29, 1968, at 53.

[162] *Investment Concerns Review Procedures to Avoid Possible Conflicts of Interest*, *supra* note 90.

[163] MARVIN L. SALTZMAN, BROKER COMPLIANCE WITH RULE 10B-5 OR AVOIDING ILLICIT COMMUNICATIONS 23 (1970).

[164] It was the policy of Merrill Lynch not to hold corporate directorships. *See* Ed Cony, *Some Stir Criticism by Sitting on Boards of Traded Companies*, WALL ST. J., Sept. 19, 1962, at 1. In the words of Michael McCarthy, the Chairman of Merrill Lynch, "We felt a conflict of interest could arise, so we made it a general policy not to serve as directors way back in 1945." *Id.* But this, of course, was not enough to prevent information leakages.

[165] *Merrill Lynch*, 43 S.E.C. at 938.

the Underwriting Division in connection with the consideration or negotiation of a public or private offering and which has not been disclosed by the corporation to the investing public."[166] The Policy further mandated that such information was "to be used by the recipient solely for the purpose of carrying out [his] responsibilities in connection with private offering . . . and not be disclosed orally or in writing for any other purpose."[167] This was the first formal Chinese Wall in the securities industry that emerged under pressure of the regulators.[168] Furthermore, a subsequent SEC enforcement action against institutional investors that obtained confidential information from Merrill Lynch advanced the development of insider trading regulation by clarifying the extent of tippee liability.[169]

Another pivotal illustration of SEC-endorsed compliance policies is the controversy pertaining to Investors Diversified Services, an investment advisor to mutual funds. In 1970, the Chief Operating Officer of the NYSE-listed Lum's disclosed to an institutional salesperson at Lehman Brothers that the updated earnings projections indicated a sharp downward revision compared to the prior estimates.[170] In his turn, the institutional salesperson conveyed that information to Investors Diversified Services, and the latter liquidated its clients' entire position of the Lum's common stock.[171] IDS settled the matter with the SEC in exchange for implementing a policy that put restrictions on transmission of inside information by IDS employees to investment companies advised

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[166] MCVEA, *supra* note 2, App. II at 257.
[167] *Id.*
[168] The *Merrill Lynch* decision is often considered as the impetus for the creation of Chinese Walls within financial intermediaries. *See* MCVEA, *supra* note 2, at 124 ("The idea of [informational] segregation was first mooted in the Merrill Lynch Statement of Policy . . . ."); Poser, *supra* note 2, at 127 ("The idea of erecting a Chinese Wall was first suggested by the SEC in 1968 as a way of preventing insider-trading abuses . . . ."). On the other hand, various internal informational barriers, such as abstaining from internal discussions or not issuing any trading recommendations in securities of companies where directorships were held, were employed by securities firms prior to this regulatory action. *See* SPECIAL STUDY, *supra* note 28, pt. 1, at 434, 436. Yet, most likely, were practices were uncommon, largely informal, and rarely enforced.
[169] Investors Mgmt. Co., 44 S.E.C. 633 (1971). *See also* Comment, Investors Management Company a*nd Rule 10b-5 – The Tippee at Bay*, 72 COLUM. L. REV. 545 (1972).
[170] SEC v. Lum's, Inc., 365 F. Supp. 1046, 1050 (S.D.N.Y. 1973). The court noted that the institutional salesperson at Lehman Brothers provided "valuable advice about rendering [Lum's] more attractive to the investment community" and was even invited to join the board of directors of Lum's. *Id.* at 1052.
[171] *Id.* at 1050. A similar situation probably had occurred in 1969, when IDS, along with other institutional investors, was thought to be tipped by Walston & Co., a brokerage firm and the principal investment banker and underwriter of AMEX-listed Four Seasons Nursing Center of America, confidential information about Four Seasons. Les Gapay, *Exchange Records Imply Walston Group Profited by Inside Information*, WALL ST. J., Sept. 12, 1972, at 1.

by IDS.[172] The policy contained a clear indication that one of the primary reasons for its adoption were the practices reinforced by the fixed brokerage commissions regime: "[I]t is the policy of IDS not to allocate brokerage in consideration of the furnishing of material inside information, and IDS employees, in recommending the allocation of brokerage to broker-dealers, should not give consideration to any material inside information furnished by any broker-dealer."[173] Essentially, that policy created a Chinese Wall within a mutual fund family. Kevin Thomas Duffy, the SEC's Regional Administrator in New York, stated that the settlement with Investor Diversified Services was a notice to institutional investors to adopt similar policies on the use of inside information.[174]

Another SEC enforcement action involved the 1970 activities of W.E. Hutton & Co., a broker-dealer.[175] The vice president of the NYSE-listed Faberge informed a securities analyst at Hutton that the company had sustained a substantial loss and would be revising its earnings estimate.[176] In response, the securities analyst alerted Hutton's branch offices, and one branch manger "telephoned a financial analyst at a certain bank . . . and recommended the sale of FBG stock. A portfolio manager of the bank ordered the sale of 3,000 shares held in one of its discretionary accounts. The order was given to Hutton and was executed . . . prior to the public release of the earnings information."[177] In other words, the implicit bargain was the exchange of brokerage commissions for inside information. Furthermore, Hutton's securities analyst tipped Investors Diversified Services, an investment advisor to mutual funds, which in turn made transactions on behalf of its clients through a different broker.[178] The Commission made a broader reference to complex kickbacks in exchange for confidential information: "[A] practice has developed of [broker-dealer] firms receiving compensation for inside information in

[172] SEC v. Lum's, Inc., 70 Civ. 5280 (HRT), 1972 U.S. Dist. LEXIS 11216, at *3–7 (S.D.N.Y. Nov. 9, 1972).
[173] *Id.* at *5.
[174] Terry Robards, *S.E.C. Tightens Control Over Inside Information*, N.Y. TIMES, Nov. 10, 1972, at 53. Yet, Lehman Brothers escaped liability – despite the SEC's efforts – because of its "compliance department, staffed by several competent and experienced attorneys, whose responsibility it was to maintain a comprehensive supervisory system for the entire organization." *Lum's*, 365 F. Supp. at 1064.
[175] Certain Trading in the Common Stock of Faberge, Inc., 45 S.E.C. 249 (1973).
[176] *Id.* at 251.
[177] *Id.* at 252.
[178] *Id.* at 251.

subsequent unrelated transactions. Indeed, the fact that the recipient may not effect any transaction after receiving inside information does not absolve the tipper of responsibility under the Rule [10b-5]."[179] Although at that time the practice of give-ups had already been abolished, Hutton probably would still have been compensated by some reciprocal arrangement. The SEC, in line with its prior emphasis on internal informational barriers, only censured Hutton and other broker-dealers and investment advisors involved "in light of the parties' undertaking to install and enforce procedures designed to detect and prevent abuses of inside information."[180]

Thus, practices of financial intermediaries reinforced by the existence of the fixed brokerage commissions regime once again led to a regulatory reaction – the creation of internal informational barriers – in order to restrict the flow of confidential information obtained through privileged access to issuers. The regulators also recommended the adoption of Chinese Walls to financial intermediaries other than broker-dealers.[181]

C. *Interaction of Various Factors in the SEC's Regulatory Design of Securities Markets*

The emergence of insider trading regulation and Chinese Walls as a result of the SEC's enforcement program during the examined time period can be attributed to several interrelated factors. The SEC's attempts to control the consequences of the fixed brokerage commissions regime closely interacted with – and, in some sense, led to – its activism in regulation information flows in the securities industry and its efforts to remove representatives of financial institutions from corporate boards. The end result is that almost all early significant cases adjudicated or litigated by the SEC pertaining to insider trading[182] – that took place on impersonal securities markets and lacked such

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[179] *Id.* at 257.
[180] *Id.* at 258. For an almost identical enforcement action of the SEC involving the transmission of the same inside information from Faberge to two broker-dealers that used it for the benefit of their clients, see Reynolds & Co., Exchange Act Release No. 10,835, Investment Advisors Act Release No. 416, 1974 SEC LEXIS 1197 (May 31, 1974). The regulatory agency also accepted the settlements on the basis that the broker-dealers would "maintain effective procedures to protect against improper action being taken on the basis of material non-public corporate information." *Id*. at *2.
[181] *See* G. Bradford Cook, *The SEC and Banks*, 89 BANKING L.J. 499 (1972) (SEC General Counsel recommending to commercial banks to establish internal informational barriers on the basis of the Merrill Lynch Policy).
[182] The role of private litigation in the creation of insider trading regulation had been minimal. "[P]rivate actions play[ed] a trivial role in regulating insider trading; the Commission ha[d] a virtual monopoly. The private actions actually brought were largely parasitic – a condition found nowhere else in federal securities

obviously questionable practices as fraudulent inducements to transact, misrepresentation, majority control, or market manipulation[183] – and the creation of Chinese Walls involved the broker-dealer industry or the closely related issue of the representation of financial institutions on corporate boards.[184]

There is no doubt that the SEC tried to micromanage the brokerage commissions rate structure. The regulators had some reservations about negotiable rates, and, as of 1966, the SEC still seemed to operate under the assumption that "a minimum commission schedule is necessary and appropriate to effective and efficient operation of an exchange."[185] Furthermore, in the words of Phillip A. Loomis, Jr., one of the most influential insiders of the regulatory agency and, successively, its Director of the Division of Trading and Exchanges, General Counsel, and Commissioner, "the most practical consequence [of negotiable rates] would be that there would be no particular incentive for anybody to be an Exchange member except specialists, floor traders, or brokers on the floor."[186] Even when the viability of the fixed brokerage commissions regime was seriously shaken, the SEC tried combat rebative practices – seen as discriminatory and unfair – and resulting conflicts of interest without paying too much attention to their ultimate cause. Up until "the beginning of the end" of the fixed brokerage commissions regime, "the SEC had never articulated an economic analysis that justified why fixed commission rates should exist in the first place nor gathered sufficient empirical data to prepare such an analysis."[187]

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regulation." Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 16–17 (1980) (footnote omitted).

[183] For the analysis of cases and SEC enforcement actions involving such questionable practices that were connected to the use of inside information and, in some sense, laid the foundation for a more general prohibition of insider trading on impersonal securities markets, see LOUIS LOSS, SECURITIES REGULATION 823–44 (1st ed. 1951).

[184] For some outliers that, in author's opinion had rather limited influence in creating and shaping the insider trading doctrine, see SEC v. Sorg Printing Co., No. 74 Civ. 3634, 1975 U.S. Dist. LEXIS 13121 (Mar. 28, 1974) (employees of a financial printer inferring the identities of targets in tender offers and trading on this information); SEC v. Shapiro, 349 F. Supp. 46 (S.D.N.Y. 1972) (partners in a M&A consulting firm and their tippees trading on confidential information about merger negotiations); Litigation Release No. 6589, 1974 SEC LEXIS 2291 (Nov. 18, 1974) (employees of a bidder acquiring stock in a target on the basis of confidential information); SEC v. Standard Sec. Life Ins. Co., Litigation Release No. 2336, 1974 SEC LEXIS 2336 (Nov. 12, 1974) (a corporate director tipping his associates about an upcoming acquisition proposal); Litigation Release No. 3225, 1965 SEC LEXIS 929 (May 19, 1965) (a corporate director trading on the upcoming announcement of a merger involving his company).

[185] PUBLIC POLICY IMPLICATIONS, *supra* note 31, at 185.

[186] Phillip A. Loomis, Jr., *Comment*, 21 BUS. LAW. 181, 182 (1965).

[187] SELIGMAN, *supra* note 10, at 403.

Indeed the Commission had engaged in policies aimed to retain the fixed brokerage commissions regime and its own control over ratemaking or, at least, manage the process of deregulation. As a result, the regulatory agency found itself entangled in many other issues, such as reciprocal practices of the brokerage industry and antitrust issues, and being in conflict with the legislators, other government agencies, and interest groups. The following quote from the speech by SEC Chairman Manuel F. Cohen before the Investment Banking Association in 1965 is quite illustrative: "Almost every regulatory problem we have concerning the securities markets is related in some way to the level or structure of rates prescribed by the minimum commission rules of the New York Stock Exchange."[188] The regulatory agency even went as far as asking the U.S. Congress to provide antitrust immunity to securities exchanges in the areas under the control of the SEC itself.[189] Not surprisingly, it was a prelude to the SEC-DOJ "turf war" over intertwined issues of the fixed brokerage commissions regime itself and the exclusion of institutional investors from the membership of securities exchanges.[190]

Obviously, the securities exchanges were interested in protecting their cartel through public enforcement. The following opinion of Professor William F. Baxter goes to the essence of the controversy: "The obvious legal vulnerability of [the fixed brokerage commissions regime] if conducted entirely by private practice has led the NYSE to seek SEC participation in the cartel decisionmaking process to afford a tenable legal shelter [and] to regulate the NYSE-member-firm complex as if the complex were a

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[188] *S.E.C. Report on Securities Markets: Discussion*, 21 J. FIN. 339, 341 (1966) (quoted by Amyas Ames, the President of the Investment Banking Association).

[189] SEC Chairman Manuel F. Cohen argued that "in matters like off-board trading by exchange members and commission rates . . . [the SEC] is in the best position to comprehend and reconcile the diverse factors and considerations" and asked the U.S. Congress "to provide antitrust immunity in areas subject to [the SEC's] review." Letter from Manuel F. Cohen, Chairman, Sec. and Exch. Comm'n, to Willis Robertson, Chairman, U.S. Senate Comm. on Banking and Currency (July 30, 1965), *reprinted in* 111 CONG. REC. 19022 (Aug. 2, 1965).

[190] SEC Chairman G. Bradford Cook later recalled his "discussions with the head of the anti-trust division on the basis that we would handle [the issues of brokerage commissions and institutional membership], and we didn't need their interference . . . ." G. Bradford Cook, Thirty Years of Change?, Historical Society Roundtable of SEC Chairmen 3 (June 2, 2004), http://www.sechistorical.org/collection/oralHistories/roundtables/SECChairmen/chairmenPapersCook.pdf (last visited __). *See also* Adoption of Rule 19b-2, Concerning the Utilization of Membership on National Securities Exchanges for Public Purposes, Exchange Act Release No. 9950, 1973 SEC LEXIS 2104 (Jan. 16, 1973); Cook, *supra*, at 3 ("[SEC] Rule 19b-2, the result of Harvey Pitt's ingenuity . . . eliminate[d] the kind of institutional membership which merely gave institutions the ability to use the exchanges without paying commissions.").

public utility."[191] Certainly, the SEC had participated in the enforcement of the fixed brokerage commissions regime even before the 1960s.[192] At the same time, the SEC was not simply an enforcement arm of the brokerage cartel,[193] and it was determined to be directly involved in ratemaking rather than simply consenting to the Exchange's proposals. The regulatory agency definitely had a mind of its own, as the NYSE-SEC tug of war regarding floor trading in the 1960s demonstrated.[194]

The initial journey of the SEC to the area of insider trading regulation or, at least, its original interest in the controversy involving Cady, Roberts & Co., was motivated by the use of information obtained by securities firms via their directorships and, more specifically, the connection of the brokerage firm's partner to the famous financial raider. While the broker's use of inside information in *Cady, Roberts*, in its turn, can be traced to the competitive pressures to supply institutional investors with inside information, there is little indication that, at that point, either the SEC or the NYSE was too concerned about insider trading as a rebative practice. There is little evidence that the securities industry, despite its support for the fixed brokerage commissions regime, actively demanded the regulatory blessings to the controls on the use of inside information. At the same time, the additional enforcement efforts by the SEC against insider trading were an integral part of its grip on control over the fixed brokerage commissions regime. Furthermore, there are indications that the SEC became initially interested in abolishing the give-up system because it interfered with the fixed brokerage commissions regime and introduced numerous conflicts of interest – not because give-ups gave rise to an organized market for inside information.

Yet another important factor in the emergence of regulation information flows in securities markets was the SEC's concern over the growing power of institutional

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[191] Baxter, *supra* note 40, at 709–10. *See also* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 6 (1971) ("[Industries] often want price controls administered by a body with coercive power. If the number of firms in the regulated industry is even moderately large, price discrimination will be difficult to maintain in the absence of public support.").
[192] *See* Managed Funds Inc., 39 S.E.C. 313, 318–20 (1959) (attacking the rebative practice of nominally employing registered representatives in exchange for commission business).
[193] *Compare* SELIGMAN, *supra* note 10, at xix (generally rejecting the theory that "the SEC has been a 'captive' of the industries it regulates") with Jarrell, *supra* note 24, at 273 (summarizing academic research as saying that "the NYSE was a [brokerage commissions] cartel, and the SEC its enforcement arm").
[194] *See* CARY, *supra* note 121, at 17; SELIGMAN, *supra* note 10, at 324–35. *See also* SPECIAL STUDY, *supra* note 28, pt. 2, at 241. ("Floor trading in its present form is a vestige of the former 'private club' character of stock exchanges and should not be permitted to continue on the NYSE or Amex.").

investors and their corresponding investment practices.[195] The regulators were certainly concerned about the use of inside information in exchange for brokerage business. Furthermore, the SEC had strong reservations about the role of discounts extended to large clients, such as institutional investors, in the fixed brokerage commissions regime: "So long as [the existing rate structure] exists, large investors should not, by virtue of their economic power and size, be entitled to obtain rebates of commissions not available to other investors."[196] This stance resonated with a more general concern about the privileged access to inside information by institutions. As SEC Chairman Manuel F. Cohen remarked, "if [institutional managers] are able to obtain from the issuer, because of their economic power or for other reasons, information that is not available to those with whom they are trading in the public market, it raises serious questions of law and propriety."[197] Consistent with this policy, a number of later SEC enforcement actions – predominantly in the context of exchange-traded securities – targeted issuers themselves for selective disclosure of inside information to institutional investors, mostly via broker-dealers but sometimes directly.[198]

Another regulatory direction was the removal of financial institutions from corporate boards, and it clearly threatened one of the brokers' main channels of supplying their customers with inside information. The rhetoric condemning "infiltration of boards of directors of issuers"[199] – the old leitmotif of the Pujo and Pecora Hearings unsuccessfully used in a later seminal antitrust case brought against the leading investment banks – still had its influence. It is quite likely that the SEC was motivated by the fact that the "centralization of important directorships [involved] (1) maximum access

[195] It is likely that institutionalization of securities markets alone would have influenced the functioning of a market for inside information supplied by brokers to their preferred clients, but the existence of the fixed brokerage commissions regime probably was the strongest impetus leading in that direction.

[196] Future Structure of Securities Markets, Exchange Act Release (unnumbered), 37 Fed. Reg. 5286, 5291 (Feb. 2, 1972)

[197] Manuel F. Cohen, *Public Policy, the Securities Markets and Institutional Investing*, J. ACCT., Jan. 1967, at 56, 56. *See also id.* at 57 ("The power of institutions to obtain information is simply one manifestation of their generalized power over the companies in which they invest.").

[198] *See, e.g.*, SEC v. Liggett & Myers, Inc., 73 Civil 2796, 1973 U.S. Dist. LEXIS 11401 (S.D.N.Y. Oct. 24, 1973); SEC v. Lum's, Inc., 365 F. Supp. 1046, 1050 (S.D.N.Y. 1973); SEC v. Glen Alden Corp., 68 Civil Action No. 3203, 1968 U.S. Dist. LEXIS 12081 (S.D.N.Y. Aug. 7, 1968); SEC v. Celanese Corp. (S.D.N.Y.), Civil Action No. 74-3453, Litigation Release No. 6440, 1974 SEC LEXIS 2963 (July 18, 1974); Avis. Inc., et al. (S.D.N.Y.), Litigation Release No. 10,672, 1974 SEC LEXIS 3430 (Mar. 7, 1974); Litigation Release No. 5918, 1973 SEC LEXIS 2861 (June 4, 1973).

[199] United States v. Morgan, 118 F. Supp. 621, 699 (1953).

to inside information, (2) maximum power to use inside information in market activities, and (3) numerous incompatible fiduciary relationships."[200] The SEC in fact participated in the litigation of *Blau v. Lehman*,[201] the case that marked an unsuccessful attempt to classify a broker-dealer as a statutory insider under section 16(b) of the Securities Exchange Act of 1934 because of a directorship held by one of its partners.[202] Indeed, it was noted that "the SEC proceeded against Cady, Roberts and Co. with principles allied to its argument in the *Blau* case."[203]

The *Special Study* endorsed the legislative override of *Blau v. Lehman*,[204] but the SEC dropped that measure from its legislative program because it jeopardized the passage of the comprehensive revisions of the Securities Acts.[205] On the other hand, the SEC largely achieved that goal via its enforcement program. Indeed, the exodus of brokers from corporate boards in the 1960s – largely because of concerns of insider trading liability – was compared to the events of the Pujo Hearings that produced mass resignations of corporate directorships by the J.P. Morgan & Co. partners.[206] Even the seemingly unrelated *SEC v. Texas Gulf Sulphur Co.*,[207] the landmark of insider trading jurisprudence, followed this pattern, as one of the defendants, Thomas S. Lamont, was a

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[200] James E. Crilly, III, Note, *Insider Status in Legal Fiction and Financial Fact – A Proposed Revision to Section 16(b)*, 50 CAL. L. REV. 500, 504–05 (1962). *See also* Michael C. Jensen, *Inside Information on Stocks Flows Steadily to the Rich*, N.Y. TIMES, May 14, 1973, at 45 ("Another practice that is under attack is the role played by officers or partners of brokerage houses who serve as directors of big corporations.").

[201] 173 F. Supp. 590 (S.D.N.Y. 1959), *aff'd*, 286 F.2d 786 (2d Cir. 1961), *aff'd*, 368 U.S. 403 (1962). *See also* Rattner v. Lehman, 98 F. Supp. 1009 (S.D.N.Y. 1951), *aff'd*, 195 F.2d 154 (2d Cir. 1952) (an almost identical factual situation and the same legal outcome).

[202] In its amicus curiae brief, the regulatory agency took the position that "it cannot be assumed in the light of the text and legislative history of Section 16(b) that a firm, which is also engaged in the business of trading securities, will ignore in its trading activities the inside information obtained from partner-directors." Alan R. Johnson & Lawrence A. Coles, Jr., *Wall Street Trading Firms as Securities "Insiders"*, 12 CLEV.-MARSHALL L. REV. 369, 377 (1963) (citing the SEC's brief).

[203] *Id.* at 379.

[204] SPECIAL STUDY, *supra* note 28, pt. 3, at 64.

[205] *See* Letter from William L. Cary, Chairman, Sec. and Exch. Comm'n, to Harley O. Staggers, Chairman, Subcomm. on Commerce and Fin. of the Comm. on Interstate and Foreign Commerce, U.S. House of Representatives (Jan. 30, 1964), *reprinted in Investor Protection: Hearings Before a Subcomm. of the H. Comm. on Interstate and Foreign Commerce on H.R. 6789, H.R. 6793, S. 1642* pt. 2, at 1201(1963-64).

[206] MARTIN MAYER, CONFLICTS OF INTEREST: BROKER-DEALER FIRMS 39 (1975). For descriptions of the resignations of some of their corporate directorships by the J.P. Morgan & Co. partners in 1914, see VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 179–80 (1970); RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 180–81 (1990). But, as of 1933, J.P. Morgan & Co.'s board representation was still very substantial. *See Pecora Hearings*, *supra* note 15, pt. 2, at 904–46.

[207] 258 F. Supp. 262 (S.D.N.Y. 1966), *modified*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 404 U.S. 1005 (1971).

director of both Texas Gulf Sulphur and Morgan Guarantee Trust Co., the successor to J.P. Morgan & Co.[208] Lamont alerted Morgan Guarantee about some important corporate developments, and, in fact, the banking house purchased 10,000 shares of Texas Gulf Sulphur on behalf of its institutional clients before the news appeared on the Dow Jones ticker tape.[209] This fact pattern is very similar to the *Cady, Roberts* affair.

It is no surprise that insider trading regulation had emerged to restrict practices of broker-dealers, an industry very familiar to the SEC.[210] Initially, this new regulatory framework had its primary effect on the brokerage industry – especially on its dealings with institutional investors and the creation of internal informational barriers. As one commentator noted, the outcome of the *Texas Gulf Sulphur* case decided by the Second Circuit and the announcement of the SEC's enforcement action against Merrill Lynch that came together in August 1968 "touched off an uproar in the brokerage industry [and created the fear that] the broker would be restricted to doing little more than selling stock certificates."[211] The SEC also aimed at transforming the state of securities analysis, largely handled by brokerage firms at that time,[212] with the view to confining the appropriate scope of research to aggregating various pieces of public and nonmaterial information rather than allowing the securities industry to take advantage of specific information obtained via privileged access to issuers. The regulatory agency had signaled

[208] Lamont continued the tradition of the Morgan representation on the board of directors of Texas Gulf Sulphur. In the past, one of the TGS directors was George Whitney – who was quizzed by Ferdinand Pecora about passing inside information acquired through his directorships within the Morgan partnership. *Pecora Hearings*, *supra* note 15, pt. 1, at 205, 207. Furthermore, Lamont was probably the most visible defendant in the TGS trial. "The publicity value of his golden name was such that it dominated a front-page headline in the [*New York*] *Times* . . . ." CHERNOW, *supra* note 206, at 565.
[209] *Texas Gulf Sulphur*, 258 F. Supp. at 273–75. Nevertheless, the district court did not held Lamont liable because his contact with Morgan Guarantee occurred after an announcement at a special press conference. *Id.* at 289–90. Lamont died before the Second Circuit revised the holding of the district court by expanding the extent of insider trading liability. *Texas Gulf Sulphur*, 401 F.2d at 842 n.6, 864.
[210] In fact, one commentator noted that, for the regulatory agency, securities market professionals have been more attractive prosecution targets for insider trading violations than corporate insiders, as the former category is "subject to direct SEC regulation and thus can be made the subject of SEC administrative disciplinary actions." MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 832 (1995). Even *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983), yet another landmark of insider trading jurisprudence, involved an employee of a broker-dealer who used for his clients valuable information "non-officially" obtained in March 1973 from a corporate insider of the NYSE-traded Equity Funding. An interesting fact is that the analyst was promised brokerage commissions for his firm in exchange for that information. *Dirks*, 463 U.S. at 649 n.2.
[211] Green, *supra* note 83.
[212] *See* John H. Allen, *Brokers Hire More Analysts, See Growing Impact on the Market*, WALL ST. J., Feb. 23, 1961, at 1 (noting that "[a]nalysts work chiefly for brokers").

its preference for the use of the "perceptive analysis of generally known facts,"[213] "information which is obtained by general observation or analysis,"[214] and "mosaic of general information, some of which is public and some of which isn't."[215]

IV. EVIDENCE FROM THE FIXED BROKERAGE COMMISSIONS REGIMES IN THE UNITED KINGDOM AND JAPAN

This Part examines the historical experiences of the fixed brokerage commissions regimes in the United Kingdom and Japan and maintains that such price restraints had strongly influenced the insider trading practices and regulation of information flows in these countries. Part IV.A extends this argument to the United Kingdom. Part IV.B extends the same argument to Japan. Part IV.C argues that the historical experiences of the United Kingdom and Japan were quite similar to the historical experiences of the United States.

A. *United Kingdom*

In the course of the nineteenth and the early twentieth centuries, the London Stock Exchange, the leading national securities market, did not have a minimum rates schedule, and the brokerage firms used different methods of charging for their services, "ranging from an annual fee from major customers, like banks, to a straight commission on each transaction from small investors."[216] The LSE introduced mandatory minimum charges in 1912 in order to protect its single-capacity system, the historic distinction between brokers that effected transactions for their customers on the agency basis and jobbers that made markets in securities by simultaneously buying from and selling to brokers.[217] In its turn, the adherence to the single-capacity system was needed to prevent non-members

[213] Cady, Roberts & Co., 40 S.E.C. 907, 915 (1961).
[214] Investors Mgmt. Co., 44 S.E.C. 633, 641 n.18 (1971).
[215] Loomis, *supra* note 82, at 25.
[216] RANALD C. MICHIE, THE LONDON STOCK EXCHANGE: A HISTORY 41 (1999). At the same time, the calls to introduce minimum brokerage charges were heard as early as 1813. *Id.*
[217] For the description of the nineteenth century origins of the distinction between these two basic types of LSE members, the Exchange's attempts to draw boundaries between these two groups, and a possible anticompetitive motivation for this distinction, see MICHIE, *supra* note 216, at 113–14; E. VICTOR MORGAN & W.A. THOMAS, STOCK EXCHANGE: ITS HISTORY AND FUNCTIONS 145–47 (1962). The single-capacity system was also perceived as a means of investor protection eliminating conflicts of interest. "Through the commitment to single capacity any client of a broker could be certain that both the price obtained was prevailing in the market and the advice given was impartial." MICHIE, *supra* note 216, at 494.

from having access to the floor of the London Stock Exchange without paying ordinary charges and hence to protect profits of the LSE's members.[218]

The increasing institutionalization of securities markets in the United Kingdom,[219] not unlike the situation in the United States, put strains on the fixed brokerage commissions regime on the London Stock Exchange. Even though the LSE was more flexible on allowing discounts to large investors within its rate structure,[220] institutional investors pressured for negotiable brokerage commissions and even launched their own direct trading network in an attempt to force the Exchange to do so.[221] Furthermore, the institutions "were in the position to expect, if not demand, some additional services for the income they contributed to broking concerns."[222] One commentator pointed out that the competition among brokers, especially for the business of institutional investors, "led to the provision of ancillary services (e.g. research) at below cost or free of charges altogether."[223] Another commentator pointed out that "institutional clients who were prevented by the fixed commission rules from negotiating cut-price dealing costs were consoled in other ways [such as free research and portfolio valuation]."[224]

Not surprisingly, brokerage firms on the LSE provided their clients with inside information: "[G]iving or taking an insider's tip was a perk of the stockbroker's job, and that doing someone a favor by 'tipping them the wink' was no more undesirable than

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[218] *See* R.C. MICHIE, THE LONDON AND NEW YORK STOCK EXCHANGES, 1850-1914, at 22 (1987) ("The restoration of single capacity [adopted in 1908 and implemented in 1909] was . . . designed mainly to restrict shunting between London and the provincial exchanges . . . . However, by simple device of nominally passing provincial business thorough co-operative brokers at minimal commission rates, this attempt to limit shunting was quickly circumvented."). For a further description of the introduction of the fixed brokerage commissions regime on the London Stock Exchange and its significance as a means to prevent "shunting," see 2 DAVID KYNASTON, THE CITY OF LONDON 434–35, 478–82. 525–28, 546–48 (1994-2001); W.A. THOMAS, THE PROVINCIAL STOCK EXCHANGES 90, 201–05 (1973)

[219] *See* HENRY LAURENCE, MONEY RULES: THE NEW POLITICS OF FINANCE IN BRITAIN AND JAPAN 75 (2001) ("The most striking trends in the postwar history of the LSE were the declining importance of private investors and the concurrent increase in prominence of institutional investors.").

[220] The LSE permitted discounts for short-term trading in the same security, reinvestments in other securities for the same account, and large transactions, as well as sharing brokerage commissions with non-members. Robert William Doede, The Monopoly Power of the New York Stock Exchange 89–90 (June 1967) (Ph.D. dissertation, the University of Chicago), *reprinted in Stock Exchange Commission Rates: Hearings on S. 3169 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing and Urban Affairs*, 92d Cong. 496–97 (1972).

[221] LAURENCE, *supra* note 219, at 75–76.

[222] W.A. THOMAS, THE BIG BANG 28 (1986).

[223] MAXIMILIAN HALL, THE CITY REVOLUTION: CAUSES AND CONSEQUENCES 2 (1987).

[224] MARGARET REID, ALL-CHANGE IN THE CITY: THE REVOLUTION IN BRITAIN'S FINANCIAL SECTOR 39 (1988).

giving a client a bottle of port at Christmas."[225] Furthermore, if brokerage firms wanted "to be thought of as experts in a particular sector, they have to be in close touch with the directors of its companies."[226] Indeed, that era was described as that of buyers going "to the broker who had the best information, and that information would be inside."[227] In other words, an important dimension of non-price competition was inside information, and, most likely, it was exploited heavily in dealings with institutional investors. The fact that LSE brokerage firms held directorships in listed companies[228] gave brokers the ability to supply their clients with inside information about listed companies, given the lax self-regulatory regime of enforcing restrictions on insider trading.[229] Such practices certainly had an effect on the emergence of a comprehensive system of insider trading regulation in the 1980s.[230]

Given the pressures exerted by institutional investors, foreign competition, and the Government's threat to bring a lawsuit on the grounds of restrictive business practices, the London Stock Exchange consented to abandoning its fixed brokerage commissions regime.[231] The transition to negotiable brokerage commissions occurred on October 27, 1986, the day known as the Big Bang.[232] One of the consequences of the transition to negotiable rates was the realization that the single-capacity system would not survive that change.

> For, were the fixed commissions to go, the brokers, with their revenue squeezed by competition, would seek an increasing dealing role for themselves in quest of compensating profits. Existing pressures for

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[225] LAURENCE, *supra* note 219, at 99.
[226] HAMISH MCRAE & FRANCES CAIRNCROSS, CAPITAL CITY: LONDON AS A FINANCIAL CENTRE 114 (1973). *See also* RICHARD SPIEGELBERG, THE CITY: POWER WITHOUT ACCOUNTABILITY 17 (1973) ("[T]he City with its closely knit information network is designed (unintentionally, albeit) to generate 'inside' information.")
[227] GEORGE P. GILLIGAN, REGULATING THE FINANCIAL SERVICES SECTOR 171 (1999) (citing Mike Feltham, the Head of the Insider Dealing Group Committee, London Stock Exchange).
[228] BARRY A.K. RIDER & LEIGH FFRENCH, THE REGULATION OF INSIDER TRADING 169 (1979).
[229] *See id.* at 160–74 (describing a rather ineffective system of self-regulation of insider trading practices by the financial community in London before the emergence of public regulation).
[230] For an overview of the development of insider trading regulation in the 1980s, see JAMES J. FISHMAN, THE TRANSFORMATION OF THREADNEEDLE STREET: THE DEREGULATION AND REREGULATION OF BRITAIN'S FINANCIAL SERVICES 195–214 (1993).
[231] NORMAN S. POSER, INTERNATIONAL SECURITIES REGULATION: LONDON'S "BIG BANG" AND THE EUROPEAN SECURITIES MARKETS §§ 2.1.4–.5, at 24–27 (1991).
[232] For the background information on the Big Bang and the numerous changes it brought for the financial system in the United Kingdom, see REID, *supra* note 224; THOMAS, *supra* note 222; G.H. WEBB, THE BIGGER BANG: GROWTH OF A FINANCIAL REVOLUTION (1987).

brokers effectively to make 'matched bargains' between buyers and sellers among their clients, and to hold stock for trading, would be immeasurably, irresistibly increased. But, if this development occurred, it would drain business from the jobbers who, in turn, would seek to trade direct with the public.[233]

Sir Nicholas Goodison, the Chairman of the Stock Exchange Council, also proclaimed that "[t]he abolition of [fixed] commission may prove incompatible with the present system of separate capacity."[234] Yet, institutional investors "did not need the protection of single capacity. They had the resources to determine if they were being cheated and the market power to retaliate."[235]

The Big Bang's abolition of the single-capacity system led to another concern: "The removal of minimum commissions . . . gave rise to pressure for the removal of the institutional demarcation, not just between principals and brokers, but also between banks and broker-dealers."[236] This was perceived as requiring "a degree of institutional separation between functions – for example, Chinese Walls between investment management and dealing on own account."[237] Thus, the *removal* of fixed brokerage commissions reinforced the need of adopting Chinese Walls.[238] The use of such internal informational barriers was in fact endorsed in the Financial Services Act of 1986 and adopted by the securities industry.[239]

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[233] REID, *supra* note 224, at 29. The re-articulation of the connection between the fixed brokerage commissions regime and the single-capacity system in 1979 is attributed to David LeRoy-Lewis, at that time, the chairman of the jobber firm of Akroyd & Smithers. *Id*.

[234] Philip Robinson, *Market Fears 'Savage' Competition After Abolition of Fixed Charges*, TIMES (London), July 30, 1983, at 11.

[235] LAURENCE, *supra* note 219, at 75.

[236] Deputy Governor, Bank of England, *Changes in the Structure of Financial Markets: A View From London*, 25 BANK ENG. Q. BULL. 75, 77 (1985).

[237] *Id.* at 78.

[238] Chinese Walls were certainly used by financial intermediaries in the United Kingdom long before the Big Bang, in part because of the concern that brokerage firms might be using inside information obtained through privileged access to issuers, and the use of such internal informational barriers was endorsed by the self-regulatory system. *See* Barry A.K. Rider, *Conflicts of Interest and the Chinese Wall*, *in* THE REGULATION OF THE BRITISH SECURITIES INDUSTRY 81, 90–92 (Barry A.K. Rider ed., 1979). On the other hand, there was a strong conflict between self-regulation in the securities industry and the competitive pressures of the fixed brokerage commissions regime, and this is one of the main reasons why the restrictions on insider trading were not well enforced. An interesting fact is that, at some point, the LSE supported the idea of public regulation of insider trading, but it later reversed its position in favor of self-regulation. *Goodison's Gaffe*, ECONOMIST, Sept. 30, 1978, at 109.

[239] Poser, *supra* note 2, at 92.

B. *Japan*

Similarly to the pre-"Mayday" United States, Japan legislatively codified its fixed brokerage commissions regime, leaving to individual securities exchanges the determination of schedules of brokerage commissions binding on their members.[240] The argument for the regime's existence was that "the reasonable commission rate is ensured because the exchange has a public character, and is under the general supervision of the Minister of Finance."[241] Such rate schedules were not necessarily insensitive to the size of a transaction. For instance, the rules of the Tokyo Stock Exchange, the leading securities market, provided for discounts up to twenty percent for large orders.[242] The brokerage business was the main source of income for the securities industry, "with average of 40 to 50 per cent for the Big Four securities firms [Nomura, Nikko, Daiwa, and Yamaichi] in any one year and 75 to 85 per cent for the smaller Japanese houses."[243] Even otherwise free market-oriented non-Japanese securities firms learned to enjoy the fruits of the fixed brokerage commissions regime as its participants: "Having paid the price and joined the club, they are content to rake in brokerage commissions and support the status quo."[244]

The growth of institutional investing in Japanese securities markets[245] and the corresponding concern about excessive brokerage commissions[246] also led to rebative practices, "usually in the form of reciprocal arrangements for services [such as] the provision of free advice on mergers and acquisitions."[247] Another means of evading fixed

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[240] Securities and Exchange Law, Law No. 25 of 1948, arts. 130-31, *translated in* JAPAN SEC. RESEARCH INST., JAPANESE SECURITIES LAWS AND RELATING ORDERS 48 (1982).
[241] JAPAN SEC. RESEARCH INST., SECURITIES MARKETS IN JAPAN 121 (1986 ed.).
[242] JONATHAN ISAACS & TAKASHI EJIRI, JAPANESE SECURITIES MARKET 34 (1990).
[243] *Id. See also* SAMUEL L. HAYES, INVESTMENT BANKING: A TALE OF THREE CITIES 172 (1990) ("Japanese securities firms are more heavily dependent on brokerage commissions than are firms in New York and London.").
[244] ARON VINER, INSIDE JAPANESE FINANCIAL MARKETS 47 (1988). In fact, the representatives of foreign securities firms met with the representatives of the ruling Liberal Democratic Party in 1991 in an attempt to slow down the process of brokerage rates deregulation. CHRISTOPHER WOOD, THE BUBBLE ECONOMY: THE JAPANESE ECONOMIC COLLAPSE 117 (1992).
[245] *See* LAURENCE, *supra* note 219, at 110–11 (describing the rise of actively-trading institutional investors, as opposed to the more traditional long-term- and cross-shareholding, in the 1980s and 1990s); Mitsuo Sato, *The Tokyo Equity Market: Its Structure and Policies, in* CAPITAL MARKETS AND FINANCIAL SERVICES IN JAPAN: REGULATION AND PRACTICE 40, 46 (1992) (noting " 'institutionalization' of equity investment").
[246] *See* VINER, *supra* note 244, at 77 (noting that, in 1980s, the major institutional investors forced the Tokyo Stock Exchange to reexamine its brokerage commissions schedule).
[247] ISAACS & EJIRI, *supra* note 242, at 34.

commission for some securities firms was "to 'buy' corporate 'research' from institutional clients. The research purchased is not needed by the firms and may be worthless; it functions as a means of offsetting commission fees."[248] Indeed, the competitive pressures for obtaining brokerage business from institutional clients were high: "Tokyo is the last major stock market with fixed commissions [where] big institutional orders are hugely profitable for the brokers, so the temptation exists to court fund managers in any way they can."[249]

Another illustration of the practices created by the fixed brokerage commissions regime is the huge scandal that erupted in the summer of 1991, revealing that both the Big Four and smaller brokerage firms had been compensating their preferred customers, such as industrial corporations, banks, insurance companies, and other institutional investors, as well as well-connected individuals, for trading losses.[250] These kickbacks were certainly an implicit discount on the brokerage charges,[251] and the commentators stated that "such compensation was a customary practice in the industry."[252] The suggestion that the loss-compensation scandal was caused by the fixed brokerage commissions regime was offered by a representative of the Japanese Ministry of Finance,[253] the ruling Liberal-Democratic Party,[254] and SEC Chairman Richard Breeden.[255]

Just like the United States and the United Kingdom, brokerage firms used inside information in order to attract and retain clients. As one commentator observed, "[b]rokers frequently, for example, offer special clients shares in companies that their

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[248] VINER, *supra* note 244, at 76. This closely resembles one of the rebative practices of Frederic S. Mates. *See supra* note 139 and accompanying text.

[249] Nancy Beth Jackson & Fingleton Eamonn, *So a Gamble Came Unstuck? Get an Ambulance Stock*, EUROMONEY, Mar. 1987, at 155, 157.

[250] For a detailed analysis of the loss-compensation scandal and its background, see WOOD, *supra* note 244, at 117–28. For the list – probably incomplete – of the brokerage firms involved and the clients compensated for their trading losses, see *Combined List of Firms, Individuals Reimbursed for Stock Losses*, JAPAN TIMES, Aug. 2, 1991, at 4. The overall amount of compensation was later estimated at about $1.5B. Yui Kimura & Thomas A. Pugel, *The Structure and Performance of the Japanese Securities Industry*, *in* RESTRUCTURING JAPAN'S FINANCIAL MARKETS 27, 48 (Ingo Walter & Takato Hiraki eds., 1993).

[251] WOOD, *supra* note 244, at 127.

[252] *Ministry Knew of Paybacks*, JAPAN TIMES, Aug. 24, 1991, at 1. *See also* MAXIMILIAN J.B. HALL, FINANCIAL REFORM IN JAPAN: CAUSES AND CONSEQUENCES 43 (1998) (stating that, despite the scandal, "the illegal compensation of favoured clients for trading losses [by securities firms] persisted").

[253] *Official Hints at End of Fixed Commissions*, JAPAN TIMES, Aug. 24, 1991, at 9.

[254] *LDP Proposes End to Control on Stock-Trading Commissions*, JAPAN TIMES, Aug. 10, 1991, at 9.

[255] *TSE Remains Cautious on Fee Liberalization*, JAPAN TIMES, Aug. 22, 1991, at 9.

inside information suggests are most likely to rise in price."[256] Another commentator also mentioned that "the cultivation of close ties to sources of information in order to obtain advance notice of significant corporate developments has long been considered an important service offered by Japanese brokerage firms."[257] Furthermore, "[i]n Tokyo inside information tends to come more from brokers than from companies . . . ."[258] Given very weak self-regulatory restrictions on insider trading on the Tokyo Stock Exchange,[259] these practices were logical. Thus, Japanese brokerage firms played the role of distributional networks of information, and those activities did not have much of a stigma attached.[260] Yet, one of the critics commented that the fixed brokerage commissions regime in Japan was one of the main reasons why "the lines between normal trading and illegal trading, such as insider trading and price manipulation, became blurred almost to the point of being indistinguishable."[261] The creation of a more comprehensive insider trading prohibition in Japan in the 1980s[262] was, without much doubt, influenced by the practices in the securities industry caused by the fixed brokerage commissions regime.

There are indications that the use of inside information by their brokerage divisions forced Japanese securities firms to pay at least a lip service to creating internal informational barriers. The use of Chinese Walls was endorsed by the Securities and Exchange Advisory Committee, a consultative body attached to the Ministry of Finance,

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[256] Leslie Helm, *Image Repairs at Japanese Brokerages*, L.A. TIMES, July 30, 1991, at D1.

[257] Larry Zoglin, *Insider Trading in Japan: A Challenge to the Integration of the Japanese Equity Market into the Global Securities Market*, 1987 COLUM. BUS. L. REV. 419, 421.

[258] ANTHONY ROWLEY, ASIAN STOCKMARKETS: THE INSIDE STORY 43 (1987). But not all confidential information conveyed by brokers was intrinsic "inside" information about issuers; some of such information constituted an advance notice about manipulative activities by securities firms themselves. "[T]he advance information that a stock will be ramped is used as an asset in itself. Such market tips are given gratuitously [by securities firms] to those individuals the firm wishes to cultivate." VINER, *supra* note 244, at 97. *See also* Jackson & Eamonn, *supra* note 249 (describing how securities firms compensated preferred clients for trading losses via manipulated "ambulance stocks").

[259] *See* Mark J. Happe, Comment, *Inside the Japanese Stock Market: An Assessment*, 5 AM. U. J. INT'L L. & POL'Y 87, 120-21 (1989).

[260] *See* ROBERT ZIELINSKI & NIGEL HOLLOWAY, UNEQUAL EQUITIES: POWER AND RISK IN JAPAN'S STOCK MARKET 116 (1991) ("The privileged distribution of inside information has traditionally been respectable in Japan because it is seen as a way of lubricating corporate relationships.").

[261] Naoki Tanaka, Op-Ed, *Face the Problem Squarely*, JAPAN TIMES, Aug. 1, 1991, at 24.

[262] For a summary of the regulatory developments in the 1980s pertaining to insider trading, see KAZUMI OKAMURA & CHIEKO TAKESHITA, LAWS AND REGULATIONS RELATING TO INSIDER TRADING IN JAPAN 83–130 (1989). *See also* Richard Small, *From* Tatemae *to* Honne*: A Historical Perspective on the Prohibition of Insider Trading in Japan*, 2 WASH. U. GLOBAL STUD. L. REV. 313, 329–36 (2003).

in 1988,[263] and securities firms also took measures to prevent internal leakages of inside information. "On July 1, 1988, Nomura took the initiative and divided its corporate finance division into an underwriting and advisory division and a brokerage division, to ensure that no sales and purchases of shares and bonds were made using information obtained from the underwriting and advisory division."[264] Other Big Four securities firms utilized similar measures.[265] Furthermore, on February 3, 1989, the Ministry of Finance has specifically ordered the securities industry not to solicit clients' orders by offering inside information,[266] and this step reinforced the role of such internal informational barriers even further. All these developments were most likely prompted by the competitive pressures of the fixed brokerage commissions regime.

The twin problems of institutional investing and international competition[267] doomed the fixed brokerage commissions regime in Japan, although the rate of change was fairly slow. The Financial System Reform Bill of 1998, an omnibus statute overhauling the Japanese economy, provided for negotiable brokerage commissions, and the last major brokerage cartel ceased to exist when the rates were fully liberalized by October 1999.[268]

C. *United States, United Kingdom, and Japan Compared*

The link between the existence of a fixed brokerage commissions regime, insider trading practices, and the emergence of restrictions on information flows has not been

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[263] Hiroshi Oda, *Regulation of Insider Trading in Japan*, *in* JAPANESE BANKING, SECURITIES AND ANTI-MONOPOLY LAW 86, 90 (Hiroshi Oda & R. Geoffrey Grice eds., 1988).
[264] ISAACS & EJIRI, *supra* note 242, at 133. *See also* Katsumi Fujimori, *Nomura Chinese Wall Sends Shock to Industry*, JAPAN ECON. J., July 9, 1988, at 4.
[265] ISAACS & EJIRI, *supra* note 242, at 133. For a description of the approval of a model policy on Chinese Walls by the Japan Securities Dealers Association and the spread of similar internal informational barriers to banks and insurance companies, see Shen-Shin Lu, *Are the 1988 Amendments to Japanese Securities Regulation Law Effective Deterrents to Insider Trading?*, 1991 COLUM. BUS. L. REV. 179, 221–23.
[266] Ministry of Finance, Ministerial Ordinance Amending Certain Provisions of the Ministerial Ordinance Concerning Rules on Sound Management of Securities Companies (Feb. 3, 1989), *translated in* OKAMURA & TAKESHITA, *supra* note 262, at 79.
[267] *See, e.g.*, JONATHAN ISAACS, JAPANESE EQUITIES MARKETS 5 (1990) ("[I]nstitutional investors themselves are leading the market towards total abolition by trading abroad in Japanese stocks listed on foreign markets where the commission rates are already lower."); RICHARD KATZ, JAPAN: THE SYSTEM THAT SOURED 334 (1998) ("[D]ue to the high fixed commissions charged in Japan, the Tokyo Stock Exchange is losing out to London, where on any given day trading in Japanese stocks is as much as 30-40 percent of the levels in Tokyo itself.").
[268] LAURENCE, *supra* note 219, at 181.

unique to the United States. In every examined case, the strains on the fixed brokerage commissions regime and the system of self-regulation of the securities industry were imposed by the growth of institutional investing, a development that was not particularly welcomed by the leading exchanges.[269] Wielding sufficient negotiation powers, and having access to alternative domestic or foreign trading venues, institutional investors were able to demand direct or indirect price reductions for securities transactions, including inside information. Brokerage firms, in their turn, played the role of clearinghouses for inside information[270] and provided such information to their preferred clients as a form of non-price competition, given the competitive pressures of the fixed brokerage commissions regime. The same competitive pressures made self-regulatory prohibitions on the use of inside information either unlikely or ineffective. Yet, non-price competition for brokerage services was still fairly inefficient compared to price competition, as the availability of various rebates had not stopped institutional investors in every country from demanding the abolition of fixed charges. Inside information as a rebate certainly had its imperfections, such as the difficulties with valuation and rationing and its likely irregularity.

No claim is made that the existence of the fixed brokerage commissions regimes in the United Kingdom and Japan played the *main* role in the emergence of the comprehensive regulation of insider trading in these two countries. Yet, without much doubt, practices of securities market professionals caused by fixed rates greatly contributed to the tightening of insider trading regulation and the regulatory approval of Chinese Walls in the 1980s in both the United Kingdom and Japan. In Japan, similarly to the United States, the competitive pressures due to the fixed brokerage commissions and attempts to court large clients pressured both the regulators and the securities firms

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[269] *See* 3 COMM. TO REVIEW THE FUNCTIONING OF FIN. INSTITUTIONS, EVIDENCE ON THE FINANCING OF INDUSTRY AND TRADE 269 (1978) (LSE's Council Chairman Nicholas Goodison arguing that the institutionalization of securities markets had increased their volatility and thus the uncertainty for companies about their cost of financing); Sato, *supra* note 245, at 42, 46, 49 (TSE Deputy President Mitsuo Sato arguing that participation of individual investors tends to stabilize securities markets while institutional investors are motivated by the "herd instinct" and contribute to market volatility and that unfixing brokerage commissions would raise the trading costs for individual investors); *Letting Institutions Join the Big Board Might Ruin Market Liquidity, Haack Says*, WALL ST. J., Jan. 23, 1969, at 3 (NYSE President Robert W. Haack opposing institutional membership and arguing that liquidity is provided by "the continuing stream of smaller trades" rather than transactions of institutional investors).

[270] *See* MANNE, *supra* note 1, at 67–68 (describing "investment bankers, underwriters, and large brokerage houses" as "clearing houses par excellence for valuable information").

themselves – that were already multifunctional – to create Chinese Walls. The impact of the fixed brokerage commissions regime on the creation of Chinese Walls was more unique in the United Kingdom: the *demise* of the regime and the single-capacity system led to the widespread formation of larger multifunctional financial firms.

CONCLUSION

Confirming Professor Manne's insight, this Article has argued that the fixed brokerage commissions regime on securities exchanges in the United States had served as the catalysis for regulation of information flows in the form of restrictions on insider trading in organized securities markets and the implementation of Chinese Walls within financial intermediaries. Historically, the SEC did have reservations about insider trading based on its vision of informational egalitarianism,[271] but the fixed brokerage commissions regime gave rise to rather extreme insider trading practices in the brokerage industry, created a system of rebates that was questionable from the standpoint of the "orderly" brokerage rate structure, and thus led to a regulatory intervention.[272] The historical experiences of securities markets in other nations also show that the fixed brokerage commissions regimes had a great influence on their respective insider trading practices and regulatory changes.

No claim is made that the securities industry in the United States "captured" the SEC and pushed through a comprehensive prohibition of insider trading and the creation

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[271] *See, e.g.*, *Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934, Hearings before House Comm. on Interstate & Foreign Commerce on Comparative Print Showing Proposed Changes in the Securities Act of 1933 and the Securities Exchange Act of 1934 and H.R. 4344, H.R. 5065, and H.R. 5832*, 77th Cong. 118, 1247–51, 1261, 1319, 1351 (1941-42) (documenting the struggle of the securities industry and the industrial sector to abolish most restrictions on transactions by insiders introduced by the Securities Exchange Act of 1934 and the opposition of the SEC to those proposals); PROPOSAL TO SAFEGUARD INVESTORS, *supra* note 131, at 21 (advocating the extension of section 16 of the Securities Exchange Act of 1934 to unlisted securities in order to prevent the use of confidential information by corporate insiders).

[272] It is illustrative that no analogous intervention had occurred before "the beginning of the end" of the fixed brokerage commissions regime. One commentator hypothesized that the adoption of computerized detection methods could have been an important factor in the emergence of insider trading regulation in the 1960s, Frank H. Easterbrook, *Insider Trading as an Agency Problem*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 81, 93 (John W. Pratt & Richard J. Zeckhauser eds., 1985), but the most prominent enforcement actions of the SEC during that era mostly likely did not depend on recent technological advances. *See also Study of Securities and Exchange Commission Hearings*, *supra* note 131, pt. 1, at 612 (statement of Anthon H. Lund, Director, Division of Trading and Exchanges, Securities and Exchange Commission) (describing the SEC's efforts in the early 1950s to continuously monitor unusual market and price movements for around 8,000 securities).

of Chinese Walls in order to protect the fixed brokerage commissions regime. The securities exchanges were interested in protecting their cartel and thus controlling kickbacks, but the NYSE in particular was not enthusiastic about scrapping non-price competition or the give-up system altogether, and it did not seem to be too concerned about its member firms using inside information to attract clients, as it was a rather common and fairly low-cost way of competing that did not dissipate profits available to the brokerage industry.

The modern insider trading doctrine originated as a form of regulation of the securities industry and an attack on the corporate insider – broker – investment banker – securities analyst – institutional investor nexus,[273] which, in its turn was rooted in the older fear of flows of confidential information within banking houses.[274] The Commission indeed complained about numerous instances "where inside information has

[273] *See also* Dooley, *supra* note 182, at 10–12 (analyzing the SEC's early enforcement actions pertaining to insider trading, observing that actions were rarely brought against corporate officers and directors as opposed to securities market professionals, noting "corporate managers' symbiotic relationship with financial analysts and other professional advisors of institutional investors," and concluding that "[securities market] professionals often used the information for the benefit of clients rather for their own benefit").

[274] Thus, securities market professionals do not necessarily lose because of insider trading, as there are trading rents that could be shared by corporate insiders and securities market professionals. *But see* Robert M. Bushman et al., *Insider Trading Restrictions and Analysts' Incentives to Follow Firms*, 60 J. FIN. 35 (2005) (presenting empirical evidence that securities analysts following increases after initial enforcement of insider trading regulation). Several commentators endorsed the theory that, because providers of liquidity, such as exchange specialists or OTC dealers, have to raise bid-ask spreads to compensate for losses from trading with better-informed insiders, securities market professionals as frequent traders are disadvantaged by insider trading because of higher transaction costs. *See, e.g.*, STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 586 (2002); Laura Nyantung Beny, *The Political Economy of Insider Trading Legislation and Enforcement: International Evidence* 9 (Harvard Law Sch., Ctr. for Law, Econ., and Bus., Discussion Paper No. 348, 2002); David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 331 (1987). But the relationship between insider trading and bid-ask spreads is quite weak, and it is largely emphasized in the academic literature rather than by liquidity providers themselves. *See* Stanislav Dolgopolov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83 (2004). One important exception concerns providers of liquidity in options markets. *Id.* at 136–44. *See also* Letter from Charles J. Henry, President and Chief Operating Officer, Chicago Bd. Options Exch., to Jonathan G. Katz, Sec'y, Sec. and Exch. Comm'n 2 (May 9, 2000) (on file with author) ("[M]arket makers on the trading floor are obliged to honor their markets and trade with . . . 'knowledgeable' orders, which can cause these market makers substantial losses, and as a result, also cause potentially, wider and less liquid options markets."). One of the main reasons for this exception is that liquidity providers in options typically do not simultaneously buy and sell the same security to profit from the spread. An options market maker on the Chicago Board Options Exchange, while commenting on his losses from insider trading, observed that "[w]ith [providing liquidity in] options, we are usually not selling from 'inventory.' Rather, we are creating the options to sell to the buyer." Dan Colarusso, *Tales from the Pits: Trapped by Insider Trading*, THESTREET.COM, June 4, 1998, http://www.thestreet.com/stocks/optionsbuzz/15765.html (last visited ___).

been cynically considered by analysts, corporate officials and money managers simply as coin of the realm."[275] This is also consistent with the conclusions of the seminal article by Professors David D. Haddock and Jonathan R. Macey that argued that the growth of insider trading regulation as a form of the protection of trading profits of securities market professionals at the expense of corporate insiders emerged only after *United States v. Chiarella*[276] was decided by the U.S. Supreme Court.[277] In fact, in the later years, until the adoption of Regulation Fair Disclosure (Reg FD) in 2000,[278] the SEC tended to ignore selective disclosure by issuers to institutional investors and securities analysts – which is a functional equivalent of selective disclosure by an issuer to or via a broker-dealer prosecuted by the regulatory agency in the past.

During the examined time period, the Commission completed its metamorphosis from "just another minor Government irritant with a bureaucrat up from the ranks as its chairman [to] an unthrottled locomotive with a wild-eyed engineer bent on obliterating everything that gets in his way."[279] The contemporary observers had indeed commented that the surge of the regulatory agency's activism was primarily based on its concerns over the fixed brokerage commissions regime and insider trading practices,[280] but the interrelation among these two regulatory pillars has largely been ignored.

In the process of its development, insider trading regulation had also acquired a life of its own and became, in the eyes of the SEC, a noble fight for investor confidence and market integrity.[281] Furthermore, in accordance with the regulatory agency's observation that the federal securities statutes had "generated a wholly new and far-

[275] Cook, *supra* note 81, at 21–22.
[276] 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).
[277] The following argument was made: "[W]hen the Supreme Court held in *Chiarella* that those without a fiduciary duty to shareholders (a status that ordinarily includes [securities] market professionals) are immune to ordinary insider trading sanctions, professionals urged and obtained stiffened penalties for insiders . . . ." Haddock & Macey, *supra* note 274, at 316.
[278] Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716 (Aug. 15, 2000).
[279] Wayne E. Green, *Spate of SEC Moves On Insiders, Fees Lead to Search for Causes*, WALL ST. J., Sept. 19, 1968, at 1.
[280] *Id.*
[281] For the respective opinions of the two SEC Chairmen that presided over the expansion of insider trading regulation, see William L. Cary, *Corporate Standards and Legal Rules*, 50 CAL. L. REV. 408, 415 (1962) (arguing that insider trading "infects the integrity of the market "); Manuel F. Cohen, *Disclosure – The SEC and the Press*, FIN. ANALYSTS J., July-Aug. 1968, at 21, 22 (arguing that "the problem of 'inside information' is one that has a tremendous impact on public confidence in the fairness of the securities markets").

reaching body of federal corporation law,"[282] the issue of insider trading was in fact a vehicle of creating uniformity in corporate governance. As a later commentator argued, "the SEC appeared to demonstrate innovativeness and flexibility by attacking insider trading under the existing general antifraud provision. Not coincidentally, the Commission solidified its position in the vanguard of the movement to federalize the corporate law and thus assured itself a central role in any future regulatory scheme."[283] In that respect, the SEC, as an entrepreneurial regulatory agency, was very successful.[284]

[282] Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961).
[283] Dooley, *supra* note 182, at 62.
[284] *See* Roberta S. Karmel, *Realizing the Dream of William O. Douglas – The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005).