NEWS

SECURITIES AND EXCHANGE COMMISSION
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WILL WALL STREET COME TUMBLING DOWN?

Address by

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Recently, when I discussed bank securities activities with a group of attorneys representing banks and bank regulators, I likened myself to Daniel going into the lion's den. Tonight, as I respond to a request to give my views on the future of Wall Street, my feelings are probably more akin to those of the three Hebrews, Shadrach, Meshach, and Abednego when they were thrown into the fiery furnace. In both of these Old Testament instances, the individuals emerged unscathed because they were correct in their beliefs. I cannot be as sure of the correctness of my views about Wall Street and our securities markets as Daniel and the three Hebrews were about their beliefs, but I feel I must be honest in stating what I presently believe even though what I say may not please the industry and even though I could change my views in the future.

Unfortunately, it is very difficult to have such a clear view of the future of Wall Street and the role that it will play in our securities markets of tomorrow, and it is hazardous to try to predict the future of Wall Street because that future contains many variables and depends upon the actions of Congress, the Federal Reserve Board, and the Securities and Exchange Commission as well as actions of existing securities industry components and others who would like to join the industry in the future.

Looking at Wall Street and our securities industry today, I see an industry which has served this nation well as a mechanism for raising long-term debt and equity capital but I do not see a modern, profitable, efficient, competitive system for trading securities. I see an industry with antiquated and anti-competitive practices. I see fixed brokerage commission rates which have contributed to fragmented markets, without a mechanism whereby orders to purchase or sell securities are assured best execution among market centers. I find costs of doing business unnecessarily high because of separate, duplicative, non-interfaced facilities for clearing, settlement, and deposit of securities. I see a system, which is geared primarily to relatively small individual retail transactions, but in which about 70 percent of the trading is done by institutions. And I see an industry which has many profitable firms, but which has experienced substantial losses over the past two years as the result of low volume, declining equity security prices, and a major reduction in underwriting business.

Some industry representatives blame their present plight on Washington and are critical of Securities and Exchange Commission practices, policies, and goals. Although

Wall Street's problems may stem to a great extent from activities in Washington, and while meaningful industry criticism does cause us at the Commission to reexamine our decisions carefully, I believe it is a serious mistake to suggest that industry problems emanate from the SEC, or that the Commission is responsible for the current financial condition of the securities industry.

There is no question in my mind that the present securities industry crisis has been brought about by some basic economic factors. The inability of Federal Government policy makers to obtain support for and to establish a successful anti-inflationary fiscal policy has allowed rapid price inflation which discourages savings and encourages consumption. Anti-inflationary tight money policies of the Federal Reserve Board have contributed to high interest rates which increase the relative attractiveness of savings deposits and other debt instruments as compared to equity investments. Taxing policies on income received from equity investments have provided disincentives for individuals to trade or invest in equity securities. And, in addition, the uncertainty and apprehension arising from an energy shortage, food shortage, increasing unemployment and political instability have caused many to reduce their participation in our equity markets.

The future of Wall Street and our free enterprise system, in which a large percentage of our citizens participate in ownership of American business enterprises through equity investments, will be greatly affected by the way Washington responds to these problems. We cannot expect equity capital to be created in the magnitude that is needed, unless past economic policies are altered to assure that the anticipated rewards for providing such funds exceed the anticipated rewards of immediate consumption purchases or alternative investments such as government securities or savings deposits in financial intermediaries. We at the SEC are very concerned about the lack of investor interest in providing equity capital, and are sympathetic to the condition of the securities industry. We are also just as interested in seeing these significant and fundamental underlying economic problems resolved as are securities industry participants, but we have neither the jurisdiction nor the power to bring about their resolution.

The industry should recognize that,in areas where the SEC does have jurisdiction, we are attempting to bring about changes in its operations and structures so that it will be more profitable, more stable, more able to adjust to changes in economic conditions, and more able to fulfill the functions for which it exists.

Apparently, however, some industry spokesmen do not see our actions in that light. We are told, for example, that we should protect and promote the industry and increase our concern with making the industry more profitable and are given suggestions as to how this should be accomplished. We are urged to switch our focus from investor protection to industry protection. This request must be on the assumption that our actions to protect investors are not beneficial to the industry, a concept which I cannot accept, and it may have the unfortunate result of further weakening investor confidence in the industry at a time when such confidence is most essential for investors to return to the market.

We are urged to protect exchange markets from third market competition by eliminating that market. We are urged to protect the industry from the market power of institutions, which are its major customers, by retaining fixed minimum commissions. We are urged to protect the industry by opposing competitive bank investment services. We are urged to keep failing securities firms in operation and, if necessary, to protect troubled firms by easing required financial standards.

Financial standards are designed to provide the Commission and self-regulatory bodies with an early warning system to spot troubled firms in order to strengthen and protect the industry as well as to protect investors. The unwarranted easing of such standards would be a disservice to both the industry and the investing public. Efforts by a federal regulator to protect an industry from outside competition and market forces in a non-monopolistic industry, which has ease of entry, usually leads to inefficiency, unnecessary duplication of facilities, and costs and prices not determined by the economic value of goods or services provided. It is difficult to deny that these conditions have developed in the securities industry.

After studying the industry, Congressional committees, industry advisory committees, self-regulatory organizations, individual industry members and the Commission have concluded that, although we still have the best markets in the world, they should be restructured and made more competitive in order to better serve the public interest as well as the best interests of the industry. Over the past three and a half years, the Commission has been attempting to assist the industry to bring about this result in an evolutionary manner and legislation with the same purpose has been working its way through the Congress.

Just last Friday, the pilot phase of the consolidated tape, the first segment of a new central market system, began operations. This tape, when fully operational, will show all trades in eligible listed securities in all markets throughout the nation. In addition, the new central market will eventually have a composite quotation system showing bids and offers by all qualified marketmakers, an automatic system to execute orders at the best price in any market center, and a central repository for limit orders. The central market also is expected to have rules requiring price priority protection for all public investors throughout the system, regardless of the order size or the market center in which the order originates. Such a system will provide more depth, liquidity, and price competition because all markets and all orders will be exposed to one another.

The evolution to a new, automated, competitive, central market system will have a profound impact on Wall Street. However, the changes and the time frame in which they will occur over a number of years are not clear and the Commission has appointed a central market advisory committee, which is presently focusing on, and will make recommendations regarding, relationships within the new system. This committee is chaired by Alexander Yearley, IV and has as members some of the most capable and knowledgeable people in the securities industry as well as users of industry services and public representatives, and we hope to obtain a great deal of help from the committee's deliberations and recommendations.

As modern communication techniques and equipment are utilized, some segments of the industry will become like a fireman on a diesel locomotive. Structuring the mechanism to preserve these segments will lead to inefficiencies in the new system. Moreover, the need for some of the functions performed by present exchanges will no doubt decline as the central system develops. In a central system, the system itself, and not the floor of any exchange, will become the market and all components will participate in the new market to the extent they are competitive in their quotations and services. Because of its present preeminence and order flow, Wall Street should do very well in the new system if it is willing to restructure its operations to take advantage of the changing environment.

Most basic among future changes which can be anticipated in Wall Street will be a shift from fixed commission rates to competitive rates on all securities transactions. Because of the magnitude of this change, the Commission has been phasing-in competitive rates over a four year period of time beginning in April of 1971. The SEC has requested that this change be completed in about six months, on or before May 1, 1975, despite increasing pressure on the Commission by the industry to either delay the date or abandon the whole idea. Several exchanges have refused to comply voluntarily with our request and, as noted in Exchange Act Release No. 10986, dated August 27, 1974, the Commission will commence appropriate proceedings promptly to determine whether it should effect changes in existing exchange rules fixing commission rates. My final judgments must await consideration of views expressed in those proceedings, but absent material information beyond that which we have already considered, you can expect rule changes allowing competitive rates to be implemented by May 1 of next year.

Although my present views on the changes which will occur in the industry as the result of competitive rates may differ significantly from what others may anticipate, I believe they are based on the operation of economic forces and sound business principles. Contrary to the widespread prognostication that competitive rates will destroy the industry and that Wall Street will come tumbling down, I believe that they will result in a stronger, more profitable and stable securities industry which will be able to react more readily to changes in economic conditions and market trends. Present competition in the industry, which is based primarily on services included in a standard price rather than on the price of individual services, will gain a new dimension as the demand for each service is determined by both the quality of the services and the price compared to the quality and price of services available from alternative sources.

Customers will, of course, react differently to this new environment. Some will not be very sensitive to price and quality differences, and, because their orders are small or routine, may not desire to shop among competitors. Such customers may well continue to choose a package of services and may prefer that payment for such services be related to securities transactions. Other more sophisticated customers, such as institutions and individuals with large orders or more active accounts, will have a greater sensitivity to the price and quality of services. In view of these differences, securities firms will naturally tailor their charges and services to meet the needs and desires of particular customers. Some customers will undoubtedly desire straight execution without related services such as research, custody, recordkeeping, delivery of certificates, portfolio planning and counseling, and will have a strong incentive to seek the lowest possible price for best execution.

Competition for such customers will cause brokerage firms to provide execution of trades at a minimum price and the option of obtaining other services on an unbundled basis to be paid for in hard dollars related to the value of the service and not to brokerage transactions. I believe this will occur for some customers even though Congress enacts legislation declaring that brokerage rate payments in excess of the minimum execution rate will not constitute a breach of fiduciary duty if the value of other services warrants the higher fees. With this legislation, however, some sophisticated customers may prefer and be able to pay one fee for a combined package of brokerage and other desired services, including research. As you may know, we have scheduled a one-day conference for a week from today to discuss this possibility as well as other related matters with interested persons.

Under competitive conditions, the quality of individual services will be maximized and prices of such services will be minimized. Brokerage business received by a firm will be based primarily on best execution at a competitive price, although the availability of other high quality services at the same firm will also tend to attract brokerage customers. It is possible that the brokerage commission rates on small trades may increase, but automated processing of such routine orders could reduce costs and thus make possible a reduction from the present fixed rates which generally include more than execution. I expect brokerage rates on larger customer initiated agency orders will be lower, and rates on orders which involve risk taking will depend on the nature of the risk, but will likely be higher.

The quality of research will be upgraded. Since I believe research will eventually be priced in hard dollars and not on the basis of brokerage commissions, it will not be necessary that it be oriented toward merchandising in order to recoup research costs. Separate compensation unrelated to brokerage transactions, for research, investment advice, portfolio analysis and other services will also reduce the incentive for brokers to churn accounts or engage in other questionable activities to create income.

I believe we can expect account executives in brokerage firms to specialize to meet the needs of different types of customers. No doubt some will continue to do about what they do today because some customers need and are satisfied with that service. Some will undoubtedly handle only unsolicited routine orders while others may function as portfolio analysts, investment advisers, or consultants on all types of financial services as firms shift, as I believe they should, more into money management services.

Payment for non-brokerage services on a separate unbundled basis will increase and stabilize the industry's revenues as it makes securities firms much less dependent on trading volume and resultant brokerage commissions which fluctuate widely. In addition, the problems of institutional membership and access by non-members to exchanges, both of which are largely an effort to recapture excess brokerage commissions, will be virtually resolved.

The fear of some marginal firms in the securities industry that their existence is imperiled by the termination of fixed commission rates is warranted and probably correct. It is reasonable to assume that the number of firms in the securities industry will contract. That contraction has already begun and will continue until it reaches the optimum number of firms needed as intermediaries to meet the demand for trading securities and related services, and raising necessary long-term debt and equity capital. I do not know how one can estimate the number of firms that will remain, but I do not believe the contraction will necessarily result in undesirable concentration in the industry, nor do I believe that there is any reason to assume that it will result in an industry through which long-term debt and equity capital cannot be obtained at a reasonable price by all sizes of firms large enough to seek public capital.

As long as firms meet economic needs, there will continue to be nationwide wire houses, and distribution networks composed of both regional and local firms. There will also be firms that specialize in execution at a minimum price, research specialty firms, and firms which offer a broad range of services. While those who cannot compete in such an environment should use their capital in other enterprises in order to maximize the use of our economic resources, well operated and efficient firms of all sizes that offer high quality services at competitive prices will not only survive, but the industry as a whole will be stronger, more efficient, more stable, and more profitable.

The future of Wall Street will be a time of change, innovation, and challenge. Many individuals and institutions will rise to that challenge and Wall Street will not come tumbling down.