COMPETITION IN THE SECURITIES BUSINESS

An Address by

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I would like to talk to you today about a subject on which there is a good deal of discussion - and also a good deal of misunderstanding - competition in the securities business.

The securities market is sometimes thought of as the perfect model of a freely competitive market - that is, one in which the prices of fungible commodities fluctuate upward and downward with changes in supply and demand, free of artifical influences or controls. To a considerable extent, this is true, and a great part of your efforts and ours are, and should be, devoted to making the securities market more closely approximate that ideal.

But the principal business in which you are engaged, from which you derive the bulk of your income, and to which we devote a substantial part of our regulatory attention, is the business of providing the necessary facilities and services for those who buy and sell securities.

This is a very different business. It is a business marked by a high degree of both governmental regulation and self regulation. It is a business that has many competitors, but in which competition assumes forms very different from those prevailing in the markets for securities.

In important areas of this securities business, the competitors have agreed among themselves to limit severely their ability to compete with one another by offering lower prices to customers for their services. When the persons who enter into an agreement of this sort constitute all, or a very large part, of the industry in which they are engaged, an arrangement of this sort can be very profitable to them, and conversely can be very costly to the public who must rely upon them for the particular service. Arrangements of this nature can therefore be justified only if they serve an important public purpose and if there is oversight by an agency of the government or some other body having responsibility for the protection of the public and investor interests.

Two principal areas in which price competition is restricted by agreement are dealings in listed securities and sales of mutual fund shares. In the first of these areas, the United States Supreme Court only two weeks ago declined to review a holding by lower courts that had upheld the right of the New York Stock Exchange to have a schedule of minimum commission rates against the claim that such action constitued a per se violation of the antitrust laws. It would, however, be a mistake to read too much into this disposition by the Supreme Court, which means simply that less than four of the Justices believed that the Court should review that particular case. Chief Justice Warren filed a strong dissenting opinion, urging that the Court should review this problem, and editorials in at least two leading publications (including one which specializes in securities matters) agreed with his position and urged that the Court should have heard the case and made a meticulous examination of the particular practices complained of in the Kaplan case.

In my view, it would be a mistake to read the decisions in the Kaplan case as meaning that stock exchanges are free to fix prices for the services provided by their members without worrying about the national policies reflected in the antitrust laws. The Kaplan case dealt only with the broad question of the right of the New York Stock Exchange to fix and to maintain a schedule of minimum rates. The decisions in that case did not deal with the question whether a particular schedule, or whether certain related practices, were susceptible to attack under the antitrust laws. It is also essential to any understanding of the matter to recall that the defendants urged, and the courts accepted, the view that an exemption from the application of the per se doctrine was available only because of the responsibility and authority of the Securities and Exchange Commission, that is, that such antitrust exemption as is available exists only because of the SEC's power to review all aspects of commission rates and charges fixed by a stock exchange, presumably in a manner which will give adequate recognition to the national policies underlying the antitrust laws. I need not tell you that we have an obligation, in which you have a vital stake, to do our job in this area, and to do it promptly and effectively. In other words,

the disposition of the Kaplan case has not detracted from the urgency of this question. It has only made possible a considered and comprehensive review of all aspects of the problem by the stock exchanges and by us, subject to review, when appropriate, by the courts. I hope that by the time you convene again next year, there will have been substantial changes in the basic commission rate structures and in related rules of the securities exchanges. A substantial part of our time over the next year will necessarily be devoted to this endeavor.

In the area of mutual fund sales charges, dealers are prohibited by law from lowering the sales load on mutual fund shares, and funds are unwilling or unable to lower them as a practical matter. When businessmen are prohibited from competing with one another by offering a lower price for their services, they will normally turn to competing by offering a more complete or more attractive service. This is a perfectly legitimate and, when kept within reason, a perfectly healthy form of competition. But it is a form of competition which requires a high degree of salesmanship, and in due course becomes what I have described as a "perverse" form of competition which places a premium on offering the highest level of compensation to the salesman - compensation which is paid for by the buyer, not by the seller.

Let me make clear that we have nothing against salesmen, or salesmanship, or carrying the message of mutual funds to the American people. We are simply not convinced, however, that mutual funds are so inherently superior to other forms of equity investment that the compensation for selling them should be fixed, without some form of control to obviate excesses and to minimize overreaching, at a noncompetitive level substantially higher than that prevailing for the sale of other kinds of equity securities, including speculative securities of much lower quality than mutual fund shares.

Up to now I have been talking about the market for providing services to investors as though it were a single market. The increasing institutionalization of the equity markets - the process by which a rapidly increasing proportion of public investors are making their investments through institutions which

pool the interests of many investors in a single legal or financial entity - has created two new facets to the traditional markets. One is the market to provide to the institutions the services and facilities which the securities business has traditionally provided to the individual investor. The other, of course, is to provide to the small public investor an interest in the institutional medium itself.

The business of servicing the needs of institutional investors is not the same as the business of servicing the needs of individual investors, any more than a sale of 10,000 shares is the same as a hundred sales of 100 shares each. There are, of course, many firms in the securities business that have recognized, and are specializing in meeting, the needs of institutional investors. Because of the commission rate structure and related rules and practices of the New York Stock Exchange, those of them who are members of that exchange cannot compete directly by offering lower prices for their services, although they can, and do, compete on a price basis through the imaginative and ingenious use of give-ups and give aways. This form of competition, however, rarely results in lower costs to the ultimate consumer, the institutional investor. They also can and do compete by offering better executions. Other securities firms that are not members of the exchange can and to some extent do compete by offering lower prices which do flow back to that ultimate consumer. Apparently they are also able to provide good executions, at least within certain limits. We believe that both price and service competition can be healthy and desirable. But the growing body of evidence seems to make more clear every day that the commission charges for the large institutional transactions which are becoming a most important component of trading in listed securities are far out of line with what the stock exchange firms which provide these services themselves consider fair compensation in these transactions. With the issue tossed squarely back to the exchanges and to us by the courts in the _Kaplan_ case, we are bound to reexamine promptly the propriety of a commission structure which demands a level of charges so high that the brokers who receive them are continually straining their ingenuity to discover more and more complicated methods of giving them away to meet the requests of professional managers of certain institutions.

It should be kept in mind that while the customers who nominally bear the cost of these high charges are large institutions, those institutions actually represent a pooling of interests of small and frequently unsophisticated investors on whom the burden of the charges ultimately comes to rest. These institutions were created to provide, and investors in them reasonably expect, that the growth of the institutions will provide the economies of scale made possible by this pooling of interests.

The business of providing institutional investment media to the public is characterized by a very different type of competition than that which characterizes the providing of investment services to the institutions. Theoretically, anyone can provide an interest in an institutional investment medium to the public at any price he wishes. In fact, however, these enterprises are only financially rewarding to their promoters if they can be mass marketed. In the case of mutual funds, it is argued that this requires that they be marketed at a fixed sales load which, together with other financial incentives, provides a return to the sellers at least as high as that offered by competing funds.

There is, however, the possibility of some price competition in this area through the entry of other types of institutions which have established channels of distribution to the public for other financial services or other types of services or commodities which they offer. These include interests in "commingled funds" offered by banks and interests in "separate accounts" offered by insurance companies. We have also heard that mutual savings banks intend to create a fund and make available to their customers interests in such a fund.

Thus there is a good deal of discussion currently whether banks should be permitted to operate commingled funds which are similar in many ways to mutual funds. The Commission, as you know, takes no position on the question whether, as a matter of federal banking policy, banks should be permitted to engage in this type of activity. The Commission has, however, traditionally taken the position - and is in fact required by the statutes under which it operates to take the position - that anyone not otherwise forbidden by law to do so, can engage in certain activities subject to its jurisdiction provided he meets the necessary qualifications and complies with the same provisions governing other persons engaged in these activities.

With respect to the provision of investment management services, the entry into this activity by others makes possible competition among different types of institutions providing in some cases the same, and in other cases somewhat different, services to the investor and marketing them in different forms. This development can to a limited extent increase the options available to the investor and reduce the price he has to pay for the services.

I must emphasize, however, that we do not believe this limited competition, even if it develops, among different types of institutions is an answer to the problems of excessive charges to which we adverted in our report on mutual funds last year and which is the subject of legislation now pending before the Congress. While there may be some overlap where competition from other institutions may be effective, different kinds of institutions often aim at, and reach, different classes of investors, many of whom do not have the benefit of effective competition. Services made available to one group at lower prices because of competition do not meet the problem of excessive charges to another group, which does not have the benefit of free price competition or adequate regulatory controls.

Not all of the competition among the different kinds of financial institutions is aimed at the consumer. A substantial part of it is often directed at legislatures, the courts and other agencies of government in an effort to establish rules which will favor the activities of one group and hamper the activities of another or to prevent such discrimination.

A regulatory agency has a responsibility to those engaged in the business which it regulates as well as to the members of the public with whom they deal. But the scope of that responsibility is poorly defined. The agency should not be a lobbyist for or against any industry, but it should stand ready to inform the legislatures and others of the contributions and problems of the industry as well as its shortcomings. But I do not believe that it is part of the function of any agency to protect those whom it regulates against competition from others who, as a matter of national public policy, have not been precluded from entering the same business except on a clear showing that such competition would be detrimental to the public interest.

In the area of financial services, securities firms, commercial banks, savings banks, savings and loan associations, insurance companies and others are regulated, to a lesser or greater extent and in widely varying ways, by a multitude of federal, state and local agencies with varying jurisdiction. Each of these agencies has the authority - and the responsibility - to apply its rules to anyone providing the kind of financial service which those rules were designed to regulate.

An important question is the extent to which a regulatory agency should seek to extend its jurisdiction over activities which are functionally similar to those of the industry for which it has principal responsibility, but which are conducted by different people and in a manner which makes it difficult to apply the agency's traditional methods of regulation. In the recent past we have asserted our jurisdiction over such diverse "securities" as interests in beavers, variable annuity policies of life insurance companies, "scholarship funds," and bank commingled agency accounts. These unusual types of "securities" have given us a good many headaches, and diverted some of our time and attention from our major function of maintaining public confidence in what are commonly recognized as the securities markets. Yet, I think this activity is essential to our basic function. If we did not take prompt action on these off-beat types of securities, we would find that a substantial portion of the talent and efforts of those engaged in the traditional securities business was being lured away--either to unregulated activities which offer the prospect (often unreal, or at least greatly overstated) of a greater immediate

return precisely because they are unregulated, or to activities governed by different sets of rules. This would result in unfair competition injurious to those who provide similar services under appropriate regulatory rules and, of course, to the public interest.

There is, admittedly, some overlap in the regulatory pattern as it relates to financial servies. Regulatory agencies do, on occasion, compete with one another just as do the industries which they regulate. But I do not see anything wrong with this; in fact, it may be one of the most constructive modern applications of the idea of federal government. Different agencies approach a problem from different viewpoints; none of the regulatory agencies has a complete answer to the economic and other problems of the securities and financial markets, and we can learn from one another. Thus, in connection with the pending question whether securities firms should be permitted to "go public," for example, we will want to add to our knowledge much more concerning the problems - and the benefits - public ownership has brought to other kinds of financial service businesses.

To sum up, the existence or lack of competition in the securities industry has a special significance. Industry and governmental responses to the problems in this area must be made within a framework which recognizes and gives effect not only to the policies spelled out explicitly in the federal and state securities statutes which govern our behavior but also with full recognition of other important public policies spelled out in federal and state laws. Your and our statutory obligations for the protection of the public and investor interests must be fulfilled in a manner which will maintain and enhance that public confidence without which the business of providing financial services will not enjoy the unparalleled prosperity it has enjoyed in at least the past two decades.