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THE COMMISSION RATE ISSUE

An Address By

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Securities and Exchange Commission

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Four months ago -- almost to the day -- my immediate predecessor, Brad Cook, addressed the Securities Industry Association on the subject of commission rates in the securities business at the Greenbriar. As a mere observer, practicing law in Chicago, I remember reading of the occasion and of his remarks and thinking to myself, once more, I'm glad that that is somebody else's problem, but I wish they would get it settled. At that point in time -- to coin a phrase -- neither I nor anyone else had any hint of what was to come. Now, four months later, I find it appropriate to deliver yet another speech on the same general subject, no longer an interested observer, but an active participant, for I have become part of the problem and must strive to be part of the solution.

Those businessmen who resent having their affairs regulated by a bunch of lawyers have no doubt not been cheered by my appointment nor by that of the other new commissioner, Al Sommer, of Cleveland. With appropriate professional parochialism, I think we have a particularly strong commission, with four lawyers leavened by

John Evans, a most able and diligent man, an economist by training, and with long service on the staff of Senator Bennett of Utah and the Senate Banking Committee.

But our past records and professional backgrounds, and how much we like and respect each other, are irrelevant. The important thing is what we do. As you surely know from the newspapers or otherwise, we did something yesterday, and that is what I want to talk about.

We reached and announced four conclusions, all relating to commission rates, namely:

- (1) We have determined not to object to the proposed increased rate schedule submitted by the New York Stock Exchange, for a period extending from the present to March 31, 1974;
- (2) Our concurrence to a further extension of the rate schedule beyond March 31, 1974, up to April 30, 1975, is conditioned upon the formulation by the exchange of two new rules, the first removing the ceiling on rates so that the rates in effect will no longer be

maximums as well as minimums, and the second permitting members to grant discounts of up to 10 percent of the fixed commission rate for special "unbundled" services.

(3) We have abandoned our program of phasing-in negotiated rates down to the \$100,000 level, either in one fell swoop or by a preliminary stepdown to the \$200,000 level.

(4) We have announced that all fixed commissions must be removed by April 30, 1975.

Our rationale for these conclusions will shortly be conveyed to the New York Stock Exchange in a letter responsive to their request for our views on its proposed rate schedule. The policies expressed in the letter will, of course, apply to all exchanges. At this time I would like to explain informally why we have reached these conclusions.

Approving the Rate Increase

We are presently living in a world of fixed Exchange commissions for all transactions involving less than \$300,000. We are also living in a world -- short-lived, I hope -- where most stock prices are depressed relative to

price ranges in the recent past, daily share and dollar volume are low, the members of the Exchange as a whole have been losing money at a frightening rate, and members' costs -- including costs not related to volume -- have risen.

The fact that Exchange members collectively have been losing money during 1973 seems indisputable. During the first seven months of 1973 they have lost an aggregate of \$194 million, and the Exchange estimates additional losses of \$53 million for August alone. The losses have not, of course, been evenly spread. Some firms who specialize in institutional business attracted by a reputation for research have not lost at all during this period, though they have not made much either. At the other extreme, some firms specializing in serving the individual investor have lost as much as \$2 million a month in recent months.

The combination of low volume and relatively higher fixed costs has caused some combinations -- mergers and the like -- among broker-dealers as well as conversions from being a carrying to an introducing member.

Alan Abelson, of Barron's, has described this process of combinations and introducing as being like rearranging

and reassigning the deck chairs on the Titanic. Exchange members, he is suggesting, are engaged in a grand right and left to see who will go under with whom.

We fully appreciate that any widespread financial failure among Exchange firms would be a disaster for our economy as a whole as well as for the individuals who would suffer the loss of their investments in the broker-dealer business and more.

We appreciate equally fully that the reasons for the losses still being suffered by member firms are manifold, many of which are beyond our jurisdiction to correct. We cannot order share volume to increase; we cannot order prices of so-called second-tier stocks to start increasing; we cannot order interest rates or tax rates to change favorably toward restoring the individual's enthusiasm for the stock market.

Under our statute, we may permit the Exchange, if it so chooses, to amend its rules to fix the higher rates proposed, as long as its proposal is not unreasonable. We think that there are valid regulatory reasons for permitting

this, even though any advantages, regulatory and otherwise, that flow from this action may prove to be relatively temporary in duration.

Of course, this is something no one can know until after it is tried. A contributing factor to the decline in revenues of member firms has been in trading and investment activities and underwriting. Higher commission rates won't help in those areas. As to brokerage transactions, many have observed that you don't raise prices in the face of decreasing demand. Although we have received some letters from irate individuals announcing that they will abandon the securities markets altogether if rates are increased, the Exchange has argued that the demand for brokerage services on the Exchange is largely inelastic relative to commission rates. In the present circumstances, that does not appear to be an unreasonable judgment of the Exchange community, and we are willing to let them find out. The fact that we have conditioned our non-disapproval for continuation of the rate schedule after March 31, 1974, as I will indicate next, does not mean that we have conditionally

approved the schedule for the next six months. The Exchange may raise its rates as promptly as it chooses for the next six months, without further condition.

Removal of the Ceiling

Continuation of these rates after March 31, 1974, however, is conditioned upon the Exchange's formulation of new rules during the coming six months. The first of these rules should remove the ceiling that, since April 1970, has transformed fixed minimum commission rates into maximum commission rates as well. As against the suggestion that the Exchange simply remove the ceiling and not raise the minimum, the Exchange has argued that nobody would dare.

The ceiling was imposed at our suggestion to guard against higher rates being charged to smaller investors. It was never intended to forbid separate charges for custodianship or research, as long as there was no discrimination against small trades. In the present circumstances, we think that firms who wish to try should be free to charge what they wish above the new minimum.

The second rule we wish the Exchange to formulate will permit exchange members to grant a discount from fixed minimum commissions of up to 10 percent, a discount which can be tied to different services offered by brokers. The Commission looks upon this proposal as preparatory to full negotiation, an experience in "unbundling" whereby, for example, a firm that wishes to offer mere execution, and not custodial or research services, may offer to his customers a lower rate. In addition, it has been suggested that firms may wish to make this sort of discount available to customers whose orders come in unsolicited by registered representatives. Experience with such a rule should be most helpful in showing the brokerage community how a totally negotiated rate atmosphere will operate, without risking the "cutthroat competition" that many witnesses in our rate proceeding predicted would arise from instituting fully negotiated rates now.

Abandonment of Further Stepdowns

As you all know, the Commission's approach to fixed commissions has been one of gradualism, removing them first with respect to very large trades and then reducing the breakpoint above which commissions would be negotiated. The \$500,000 limit, adopted in April of 1971, was reduced to \$300,000 in April of 1972. At that time and in subsequent testimony, the Commission stated that it planned to reach a \$100,000 breakpoint in April of 1974, in one or more steps.

This program was avowedly experimental from the outset, at least to the extent that the timing of any incremental stepdowns would be governed by conditions from time-to-time. In April of 1973, the Commission announced that owing to the impact of massive regulatory initiatives applicable to the member firm community and to the serious losses incurred during the first quarter of 1973, there would not be an intermediate step taken during that year towards the \$100,000 goal. While we believe that the \$500,000 limit and the step to \$300,000 were constructive

for the industry, in focusing attention upon the problems that had arisen over the years from the fully fixed rate system, and achieved their intended purposes in moving toward removal of some of the particular inequities that had caused dissatisfaction, we no longer think -- having observed the effects of the first two steps -- that any further ones would be constructive. They now seem to resemble trying to be merciful by cutting off the arm slowly. Further adherence to our gradual phase-in program would preserve rigidity in charging rates that could hamper member firms in altering their charges to take account of cyclical and other industry factors.

Abolition of Fixed Commissions

Why do we think fixed commissions must be removed altogether after a year and a half of warning and preparation? One friend of mine with a major firm has written me recently, more than once, about the absolute necessity of preserving fixed commissions and restoring them above \$300,000. In his latest letter he has warned that removing fixed commissions will do him out of a job -- and me too! -- since I will have no industry left to regulate.

There are, in our opinion, several cogent reasons for insisting upon this final step at this time as of a day certain, but popularity in this room or elsewhere is obviously not one of them. I might say, however, that I have received more letters and other communications from persons in the industry saying for God's sake drop the other shoe and get things settled and definite. So, while we expect to be publicly unpopular for taking this move, I am sure we haven't surprised many people, and I even think most of you will ultimately agree that this approach was the right thing to do at this time.

The reasons in favor of the move begin with the fact that the present situation is unstable and cannot endure. The good old days of ten years ago are gone and cannot be restored. To those who loved them, I extend genuine sympathy. That is not the only feature of the world in 1963 that I might prefer to the world of 1973. But there is no use pining. It won't come back.

Fixed commission rates were justifiable in 1792, when they were first implemented, and must have been in

1934, when Congress gave them legislative sanction. But in the present structure of the industry and the Commission, fixed rates simply cannot long survive. There are sound regulatory reasons for permitting them to be retained until April 30, 1975, but certainly no later, however, so that member firms which justifiably have structured their business operations in reliance upon fixed rates may prepare to eliminate them without causing any economic fallout or erosion of service to investors.

We have not made the elimination of fixed commissions a condition to our non-objection to the present rate increase, as some have suggested. There are several reasons for this, the most important of which, to my mind, is that acting in that manner would suggest that the Exchange community has a choice, and that might lead to a prolonged internal controversy over which choice to make. Such a result would not be productive.

If the Exchange membership thinks that the proposed rate increases will help to get them through the night of present market conditions, they should move promptly to put them into effect. But whether they do or not, we shall

proceed toward the elimination of fixed commissions. The elimination of fixed commissions is then not the price the members must pay for raising rates now. It will come anyway.

The prevailing exchange approach to commission rate charges largely has been a stop-gap or reactive approach. That is, as conditions have changed, there has been a tendency to come forward with temporary resolutions, designed to shepherd the exchange community through the then-prevailing crisis. To some extent this was a necessary approach. Many of the factors we have observed were, in 1968, only first beginning to be comprehended.

But the Commission is charged with broad oversight of exchange rules and policy initiation. The rate question, like so many other current problems, requires a broad policy approach. The difficulty, of course, is that, while efforts are made to implement broad policy, it would be inimical to the interests of the investing public, persons seeking to raise venture capital and the securities industry if we were to permit the prevailing situation to

deteriorate to the point where any broad policy initiatives ultimately formulated would prove to be too little and too late. Our solution is to implement needed changes of both short and long duration.

Those who have followed bills in the Congress will recognize that our long-range program parallels that proposed by Mr. Moss in Title II of H.R. 5050 -- the Securities Acts Amendments Bill of 1973 -- now pending before his subcommittee, except that his bill provides for stepdowns to \$200,000 and \$100,000. We intend to advise him of our present views on the stepdown feature and then to observe the progress of his bill. Obviously any act of Congress will supercede any rule or order we may adopt.

However, Mr. Moss's bill and the counterpart bill on the Senate side involve other features. There are differences among them, and some are quite controversial. This may delay the legislative program, which is why we shall proceed to the elimination of fixed commissions under the powers given us in the Securities Exchange Act, unless Congressional pronouncements intervene. Meanwhile, of course, we will consider carefully any proposals to this end submitted by the exchanges.

In a number of ways, the Commission's conclusions mark the end of an era, as well as the end of an extended period of time during which these issues have been virtually debated to death. But I am hopeful that it may also be a beginning--the beginning of a new period in the securities industry based on economic reality, modern equipment and business efficiency, as well as continuing in the tradition of service to the public and effective cooperative regulation that we have seen in the past. These are uncertain times, but no one can say that we are sailing into an uncharted sea. Hopefully the end of our journey will see renewed investor confidence, increased vitality in the industry, and a strengthened position for America's capital markets in the world economy.