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(202) 755-4846



THOUGHTS ON APPROACHING "MAYDAY"

An Address by

A. A. Sommer, Jr., Commissioner
Securities and Exchange Commission

University of California
Securities Regulation Institute
San Diego, California

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A. A. Sommer, Jr.*
Commissioner
Securities and Exchange Commission
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Rumor has it that within a week or so the Commission is going to come to grips finally and decisively with a problem that has plagued it since 1968. Since that time it has been hashed over in three separate sets of Commission hearings and hearings before two committees of Congress; it is presently the subject of a case pending before the Supreme Court and another in a District Court in the Seventh Circuit; it has been the subject of more essays, submissions, scholarly articles and oral confrontations than perhaps any subject in the history of federal securities law.

The problem, of course, is that of fixed commissions on the securities exchanges of this country.

There is a good deal of speculation abroad in the land concerning the direction the Commission will go on the matter. Some, like the New York Times last Sunday, rather confidently foresee that the Commission will opt for the elimination of fixed commissions although it wisely hedged its bet by declaring that such is by no means certain. The threat has been made clearly and unequivocally that if the Commission does so move it can expect to be sued -- I think the words were something like, "Tell them I'll meet them on the steps of the Court at Foley Square..."

I do not intend to inkle the outcome of our deliberations today. I can say with all honesty the decision has not been made. I dissemble not

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when I say I don't know how the decision will come out, though candor does compel that I own to some suspicion concerning the broad outlines the decision will take.

It is not my purpose today to discuss this forthcoming decision or even my own convictions with regard to it, though I suspect some of my remarks may hint at those convictions. Rather it is my purpose to discuss somewhat generally the developments in the U.S. capital markets which brought us to this moment of decision making.

Exchanges, in the sense of groups of men organized for the purpose of engaging in securities transactions, go back pretty much to the founding of the republic, though their structure and organization were then relatively loose. The first formal constitution of the exchange which is now the New York Stock Exchange was formulated in 1817 and was modeled on that of the Philadelphia exchange, which at that time enjoyed greater standing and prestige than did the New York counterpart. However, prior to that, in 1792, the members of the then loosely organized group of New York brokers who were engaging in transactions in securities entered into the famous Buttonwood Tree compact under which they agreed that they would not

"...buy or sell...for any person whatsoever, any kind of public stocks at less rate than one-quarter of one percent commission on the specie value, and that we will give preference to each other in our negotiations."

This agreement, of course, predated by a century the Sherman Act. Notwithstanding the advent of antitrust concerns, this kind of limitation and others equally at variance with the rising hostility to combinations and contracts restrictive of trade nonetheless continued unchallenged. The New York Stock Exchange, and the other exchanges as well, were regarded by their members and by the public as well as gentlemen's clubs and as such had the right to govern their affairs in a fashion that presumably permitted only gentlemen to be members and to lay down rules that protected the club and its members from unwanted influences.

All this seems to have escaped the notice of the antitrust authorities, for we read of no assaults on any conduct of the securities exchanges until the Silver case in 1961, and even that was initiated by a private litigant. In a sense, perhaps, until the twenties these exchanges were not really much freighted with public interest. For the most part the general public was not concerned with the conduct of the exchanges; the number of Americans who bought and sold securities for their own account was relatively small and these were for the most part the well-to-do. After all, there were much juicier targets about for the antitrust enforcers: the oil trust, the sugar trust, the cement trust and so on.

The twenties, however, brought a new era and the public found the stock market. During the years leading to 1929 millions upon millions of modestly situated Americans found what they thought was the road to riches and began the greatest speculative splurge since the day of the South Sea Bubble. By today's standards even then a relatively few Americans held stocks, but the mix had definitely moved in the direction of citizens of more modest means and less sophistication about the operations of the securities markets.

With the crash in 1929, of course, came the inevitable post-mortem. The manner in which the exchanges had been doing business for a century and more was subjected to the most minute scrutiny and the spectre that spread out on the congressional record horrified Congressmen and Senators and shocked the citizenry. They found a mechanism which insiders had abused adroitly and in many instances quite legally to denude innumerable small investors. They heard stories of "bear raids," "wash sales," "painting the tape," and all sorts of other manipulations. Suddenly it was apparent that the exchanges, and particularly the New York Stock Exchange, must be more than private clubs at the hands of which the public, if it ventured into their domain, would be victimized if they became entangled in the complex schemes developed by the insiders playing their high-stake game. It was apparent that they were in truth quasi-public institutions and that they must answer to the public for their conduct.

Out of this realization came the provisions of the Securities Exchange Act of 1934 which provided for the licensing of exchanges, forbade certain practices which had characterized their operations previously, and gave the newly established Securities and Exchange Commission broad oversight with respect to the exchange activities.

This legislation appeared to sanction rules of exchanges which might, absent the statute, run afoul of the antitrust laws. Among such practices apparently countenanced by the 1934 Act was the establishment of minimum commissions by exchange rule subject to oversight by the Commission.

Under Section 19(b) the Commission was given the power, after request to an exchange to make a change in its rules, and its refusal to do so, to "alter or supplement" the rules of the exchange with respect to certain matters, including "the fixing of reasonable rates of commission, interest, listing and other charges."

Through the years the Commission exercised this power with considerable restraint. Typically proposals by exchanges to adjust their commission rates were filed with the Commission and the Commission would forego objections without searching inquiries, largely because the Commission was not structured for the kind of ratemaking characteristic of the ICC and the CAB. It was not until the mid-sixties, in fact, that the Commission began to scrutinize actively such requests and review with care and in detail the justification for them. In 1968 for the first time the Commission overtly raised the question in public hearings whether there was any need at all for the continuation of fixed commissions.

To some extent this inquiry arose out of a series of court decisions that raised serious questions concerning the breadth of the protection afforded exchanges by the 1934 Act. In the first of these, Silver v. New York Stock Exchange, the Supreme Court suggested that the antitrust immunity extended only as far as necessary to make the 1934 Act work; subsequent cases followed a similar approach, with some variations in the phrasing of the test. In 1963 Thill Securities Corporation, a non-member of the New York Stock Exchange, filed suit against the Exchange charging that by maintaining a fixed commission structure the Exchange and its members had engaged in an illegal price-fixing conspiracy. The Court of Appeals for the Seventh Circuit determined that fixed commissions were not per se exempt from the reach of the antitrust laws and remanded the case for trial

to the district court, which did try it in extenso and which has not yet made its decision. Meanwhile, a case posing the same issues, Gordon v. New York Stock Exchange, was decided by the Court of Appeals for the Second Circuit. It determined that the Exchange's fixed commissions enjoyed immunity under the antitrust laws, but alluded in its opinion, in a manner which has led some to think this was a decisive consideration, to the decision of the Commission on September 11, 1973 to take action to eliminate fixed commissions as of May 1, 1975 if the exchanges had not done so by then. The Supreme Court has granted certiorari in the Gordon case.

After decades of dormancy the Antitrust Division of the Justice Department has apparently made the elimination of fixed commissions on securities exchanges a major policy objective. It intervened in the Thill case, it has filed suit against the Chicago Board Options Exchange attacking its fixed commission structure, it has filed extensive memoranda in connection with each set of Commission hearings, and it has made its views known to the Congressional committees which have considered the issue.

Not surprisingly, while this subject was coming front and center in the courts and at the Commission, Congress became involved. As an outgrowth of the massive failures of securities firms in the late 60's and early 70's and the agonizing snarls in the back rooms of the industry, not to mention the other issues which afflicted the securities markets during this period, both houses of Congress launched the most thorough scrutiny of the securities markets since that which preceded the 1933 and the 1934 Acts.

They received extensive testimony on many, many subjects, including the problems of clearance and settlement, institutional membership, and of course, fixed commissions. As a consequence of these studies both houses of Congress framed legislation which would have, albeit on different schedules, eliminated fixed commissions. As you know, the Senate passed its legislation. In the House, H. R. 5050 was reported out by the House Committee on Interstate and Foreign Commerce by a vote of 39 to 1, but failed to reach the floor of the House because of a 6 to 6 deadlock in the House Rules Committee occasioned by the departure of a committee member, who purportedly favored granting a rule for the legislation and allowed it to go to the floor, to keep a six month old dentist appointment just before the vote was taken. This somewhat anomalous result was described by the chairman of one exchange as a "mandate" of Congress, which the Commission should heed, against unfixing commissions, a construction which drew during the course of the Commission's hearings last month rather startled inquiries from some of my fellow Commissioners about the basis for that strange characterization.

Meanwhile, back at the ranch as it were, on September 11, 1973, the Commission announced that it expected the exchanges to eliminate all fixed commissions prior to May 1, 1975, and indicated that if they did not do so the Commission would take appropriate action. We have now gone through the necessary preliminaries to our action: we asked the exchanges to adopt rules eliminating fixed commissions and all but one have told us they will not do so; we have proposed a Commission rule to accomplish the unfixing and have had hearings on it, and now there has come the time for decision.

All of this, in a sense, is prologue. It is intended to give some indication of the attention which has been focussed on the issue, the extent to which it has been studied and pondered and discussed and chewed and debated. Understandably the issue is one of great consequence to the securities industry and to the nation. One does not lightly tamper with a practice that has endured for almost two centuries and that has been an integral part of, though not necessarily a reason for, the development of an efficient and durable market system.

During all this time several major changes were occurring in the securities markets of the nation. Surely none was as monumental as the growth of so-called institutional trading. During the period from 1963 to 1972 transactions that might be called institutional increased almost sevenfold; from about forty percent of the volume on the New York Stock Exchange in 1961, the amount institutions accounted for grew to nearly seventy percent in 1971. As the total accounted for by institutions grew, so did the typical size of their transactions; more and more of their trades were for ten thousand shares or more.

Many factors accounted for this phenomenon. For one thing, our tax laws encouraged the accumulation of funds in institutional hands. When Congress first gave special tax treatment to contributions to pension and profit-sharing trusts and in the income therefrom by encouraging accumulations in institutional hands, it unwittingly started to create new problems

in the securities markets. As the nation grew more affluent, estates and private trusts grew and became managed by banks and other institutions; more and more people invested in life insurance and annuities, with consequent growth in those portfolios; increasingly people began to respond to the proclaimed benefits of mutual funds and vouchsafed their savings to those institutions; educational institutions were increasingly successful in building endowment funds. Assets held by institutions increased from \$558 billion in 1965 to \$924 billion at the end of 1973. The old lure of equities beckoned not only individuals but institutions as well, with the result that increasing amounts of these funds were invested not in conventional long-term debt securities which had been the pattern of the past, but rather in common stocks. In some measure this was the fruit of a felt concern that gradual inflation perceived and even advocated by some could be neutralized by equity investments. It was also the consequence of the advent of the "total return" concept that encouraged fiduciaries to look not only to the actual cash yield of a security, but its increase in value as well. During the sixties, as money managers pondered these concepts, it made good sense: during the time from 1960 to 1969 the Dow Jones average increased by an average 13 % per year and unbridled optimism was once more abroad in the land.

Thus not only was there more money in institutional hands for investment, but more of it was being invested in equity securities. This, along with the enthusiasm of individuals, quickly obsoleted the New York Stock Exchange's prediction in 1965 that in ten years volume would average 10,000,000 shares daily; it has averaged that every year since 1967, including 1973 which was such a disaster for much of the securities industry.

Another factor also played a role in all this. Not only did money managers look to the "total return" concept, but many of them became enamored by the idea of "performance," which was, I suppose, an outgrowth of the "total return" concept. This fad placed emphasis upon the gains to be secured by short term trading, with the result that the turnover rates of institutions, which had been in the neighborhood of 12-14%, for some groups went as high as 30-33%, thus injecting additional volume into the market.

All of this had many consequences. The manner of trading changed. You simply cannot handle an institutional order to buy or sell fifty thousand shares the way you do an order to buy or sell a hundred or two hundred shares. The exchange mechanism had been developed in an atmosphere characterized by individual dominance. Specialists were generally individuals or small firms with limited capital, sufficient for the old markets in which the principal participants were individuals and a thousand shares was a big order, but hardly adequate to field the new brand of order that often went into numbers of shares in five or six figures. Specialized skill in finding the other side of such orders was necessary, a skill that specialists simply could not exercise, even if they had it latent, given their floor responsibilities. Institutions often demanded instant liquidity: though some were happy exceptions, many would expect almost immediate liquidation of positions they may have spent weeks accumulating.

To meet these new demands the securities industry to its everlasting credit developed the skills and the techniques and committed the capital necessary to satisfy the desires of this new breed of customer. Exchange members became block positioners: bound as they were by rules of the exchange which forbade them to execute trades in listed securities off the exchange, they would accept an order, search for the other side, check out the specialist's interest, cross to the extent they could, take the rest themselves as principal, and with everything arranged, go to the floor for execution. Non-members of the exchange developed the so-called third market, that is, the over-the-counter market for listed securities and dealt as principal in them. Uninhibited by the necessities of charging a fixed commission and taking the transaction to the floor for execution, they often found favor with institutions because of the uncomplicated manner in which they could do business; they would simply make a net bid or net offer.

The institutions early on realized something. They realized that theirs was indeed lucrative business for a New York Stock Exchange broker. Prior to 1968 a customer paid the same commission per share on a hundred share order for a stock as he did for a ten thousand - or a hundred thousand share - order for the same stock. The institutions quickly

sensed the inordinate profit opportunity this arrangement afforded brokers and which to some extent continued even after volume discounts were instituted. Thus they developed a variety of arrangements with respect to that extra margin of profit that accrued from their business. In some instances they directed that a portion of the commission be paid to another exchange member who may have provided them with services, such as research. In other instances, availing themselves of the liberality of regional exchange rules, they organized broker-dealer affiliates which joined a regional and made reciprocal arrangements with New York members which handled the institution's trades on the New York Stock Exchange for the execution of some of that broker's transactions on the regional. And, of course, they often availed themselves of the third market which was unconstrained by any minimum commission structure. When customer directed give-ups went by the board, increasingly the business of institutions was sought through the lure of high-grade research, research that was of course funded with the extra dollars provided by the fixed minimum commission structure.

These devices for avoidance of the stringencies of the fixed commission system, coupled with the new interest of the Justice Department in all of the restraints which have characterized the exchange system, placed on the compensation structure of the exchanges unprecedented pressure for change. Since 1968 change there has been: in 1968 the volume discount was initiated; in 1971 fixed commissions were eliminated on all transactions over \$500,000 in amount; in 1971 the 40% non-member access discount was begun, i.e., a non-member broker-dealer could secure an execution by paying a member 60%

of the minimum commission; in 1972 fixed commissions were eliminated on all transactions over \$300,000; in 1973 commissions were unfixed on transactions under \$2,000.

As we approach the moment of final decision on the fate of the remainder of the fixed commission structure we are confronted with an industry that has been going through a severe contraction with heavy losses suffered by many of the survivors, though it should be mentioned that through all this there have been firms that have managed consistently to turn profits. For a while the securities industry seemed to be suffering alone; now it has the company of the automotive industry and others as well. The presence of these adverse economic circumstances has, of course, encouraged many to urge the Commission to forego action until there are balmy times.

The discussions concerning the end of fixed commissions have become increasingly harsh as the time for decision has approached. Many untoward consequences have been foreseen if we take this step. It is said that it will spell the end of much valuable research that has been made possible by the dollars in the fixed commissions which are in excess of the cost of execution and that as a result small and medium sized institutions which do not have the resources to create a full research facility or to buy the research products of others with so-called "hard dollars" will be unable to compete with larger institutions which have these resources. Concomitantly, it is said, many securities firms which have been built on quality research will be unable to survive unless somehow or other their institutional customers can be assured

that paying commissions in excess of those payable for simple bare bones execution will not be a breach of their fiduciary duty to their beneficiaries.

It is suggested that the cessation of fixed commissions will further shrink the securities industry, with many firms unable to compete and survive in a competitive rate atmosphere. And it is said that the economics of the industry are such that only a few giants will survive and those not necessarily the most efficient. And there is a cry that as this shrinking occurs, the ability of the securities industry to perform its historic role of raising capital for American enterprise will be irreparably impaired, if not destroyed.

It is urged in the strongest terms that the onset of competitive commissions will be the demise of the New York Stock Exchange for, say these people, the cement which has held the Exchange together through the years has been the benefit members derive from the fixed commission system. Without it, it is said, members will leave the Exchange, make markets "upstairs", send only bits and pieces of their business to the floor, and eventually the specialist will tire of being the junk dealer and go "upstairs" himself. And this, it is said, will mean a lower quality of regulation, for the admirable (and I agree it has been admirable in many respects) regulatory structure built by the Exchange community will be deprived of financial support.

And there are others who foresee the demise of the regional exchanges, whose lifeblood, it is said, has been the ability to offer a means for institutions to escape the rigors of the fixed commission system.

In any event, all the arguments are in and the time for decision is upon the Commission. I would like to share with you a few final reflections about this matter.

First, whether the Commission decides to pursue its goal of eliminating fixed commissions on May 1, 1975, or not, I am sure that the day of the fixed commissions is fast ~~er~~ iring. If we don't do it, Congress will; the sorry events accompanying the death of H.R. 5050 did not dampen in the slightest the determination of those associated with that and companion legislation in the Senate to bring about the reforms incorporated in that bill, including the end of fixed commissions.

Second, there will never be a "good" time for achieving changes in the securities industry. In 1972, Alan Greenspan, now Chairman of the Council of Economic Advisors, suggested in testimony before a Senate committee that "the transition period should not be concentrated in periods of high stock exchange volume and profitability." While he was speaking of the transittional phases, I think the same can be said of the final phase. It may be much easier to chart the impact and take remedial action during times like these than during times when the honey flows in abundance.

Third, I think the dire consequences foreseen are, as similar predictions made in the past in the face of reform have been, grossly exaggerated. I have read literally thousands of pages of testimony, submissions, articles by economists, and have listened to endless hours of testimony, and have engaged in countless conversations with people of all beliefs. I believe that great changes will come about as a consequence of the elimination of fixed commissions, whenever it comes, but I sincerely doubt whether any of those changes will distress the efficient, handicap the capital raising process of the country, reduce the New York Stock Exchange to a shambles (in fact, it is easier to foresee a time of restored vitality than it is a time of distress there), or destroy the securities industry. Rather, I think it is easier to identify affirmative benefits that will derive from this change. There will result greater rewards for efficiency, and in the wake of that everyone, individual and institution alike, will benefit. Already there are evident some of the fruits of this new potential price competition: firms are developing new packages and types of service to lure the business of individual investors. People will no longer be paying for parts of the total services heretofore gathered under the umbrella of fixed commissions they do not need or want. Much of the gimmickry which has been bred by fixed commissions will go by the board, to be replaced by honest, straightforward, competitive pricing that relates price to the cost of rendering the service plus a reasonable profit. The fundamental laws of economics will determine pricing.

I am convinced that competitive commissions will usher in a new and better era of public participation in the markets. For too long compensator practices in the industry have been tied to the transaction, with little concern for the overall welfare of the customer's portfolio; no salesman ever made money telling customers to "hold" securities. I think the elimination of the fixed commission will result in the development of a variety of financial services which will be of value to customers and for which they will pay in non-transaction related manners. The result will be the increased professionalization of the industry and much greater service and benefit to the customer.

Undoubtedly the change to fully competitive commissions will bring great changes to the industry. Some elements of the industry will be benefited by them, some hurt; everyone is confronted with the necessity of using the most ingenuity and imagination to adapt. By May, 1975, the industry will have had over a year and a half since the first indication of the Commission's determination that fixed commissions end then. That in my estimation will have been sufficient for the planning, the adaptation, the preparation for this new era.

As we pass through Mayday, again assuming the Commission mandates the onset of the competitive commissions on May 1, 1975, I think it is imperative that we monitor with care, constancy and precision the manner in which this change affects the industry. I have recommended strongly to the Commission that, if we so decide, we, in conjunction with the self-regulatory agencies,

establish procedures and mechanisms to identify promptly and accurately all of the changes induced in the industry and its ways of doing business as a consequence of this change. In addition, I have urged that we develop contingency plans for dealing with any untoward and undesirable trends which may develop, such as an unwholesome fragmentation of the market in listed securities. None of us, neither Commissioners nor industry leaders, are fitted with twenty-twenty foresight and none can peer into the future and discern what may happen with complete confidence. We can however assess promptly what is happening and be prepared to deal intelligently with consequences as they occur. Instead of mounting the ramparts for a fruitless legal battle, it seems to me all of us concerned with these problems might better be preparing the mechanisms for cooperation to accomplish these tasks of careful observation and quick response.

It may well be that one or more units in the industry will see fit to attack in court our determination, if we make it, to unfix commissions on May 1, 1975. Speaking as a lawyer, I think they will be tilting with windmills and spending money in a lost cause. It may well be that some will think that litigation will buy additional time in which to enjoy the benefits of the fixed commission system even if the litigation is unsuccessful. I would consider such thoughts unworthy of an industry, or a segment of it, which has throughout this debate insisted on its dedication to, and concern with, the public interest. If some choose to put the issue to the courts,

they will not want for an adversary there; but they should bear in mind the danger that a continuation of fixed commissions, beyond the time when the regulatory body possessed of the expertise and authority the Commission has determined such are no longer in the public interest even though litigation pends, may invite ruinous attack upon those who continue to abide by the fixed commission structure.

These are the somewhat random reflections of but one of the five who must in the near future make this decision so vital to the capital markets of our country. It has been suggested that we unfortunately lack experience in the securities industry, or that we are afflicted by the attitudes of our staff, or that we do not understand the problems, and it has been suggested that not too long ago - say before July, 1972 - the Commission was more responsive to the problems of the industry. We claim no monopoly on wisdom. But as we approach this time of decision - perhaps the most important decision most of us will make as Commissioners - we do it with confidence that we have studied hard the problem, listened carefully to the arguments, weighed cautiously the varying views, and conscientiously sought to do that which we think right and good for the public interest. None of us can do more.