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QUALITY SERVICE IN BROKERAGE

by

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Here at the outset of the final quarter of 1972, it is a good time to assess the current year and look forward into the next.

There is no need for me to review with this audience the forces for change, the problems you face and the goal of a better market system attracting broader public participation by providing better service for more investors on a sound economic basis. That way lies the general public interest.

You have been required to adapt to significant change, negotiated rates at lower levels -- we have all studied further change in the rules and structure of the markets -- you have been asked to improve your capital structures, your reporting and your handling of customer's assets. Between now and the end of the year, the Commission, with the guidance of formal comment from the self-regulatory bodies, firms and associations which make up your industry, plans to speak further on the composite tape and the rules of the central market system. There is reason to hope that the direction will be reasonably clear by year end so that 1973 can be a year of implementation and movement.

The Commission is aware that, in the discharge of its regulatory functions, it has imposed additional costs and burdens on you and others engaged in the investment process. We want to avoid the fallacy of continually piling it on and never looking to see what can be peeled off. We have persuaded some 20-odd experienced and knowledgeable men to serve on three advisory committees to review the reporting, regulatory and recordkeeping requirements laid on the industry by the Commission and the self-regulatory bodies to see if they can make recommendations on how reporting and other requirements under which the industry now labors can be made more effective or less burdensome or both. One committee will examine this question with respect to broker-dealers, another with respect to issuers, and the third with respect to investment companies. We are asking them to make a quick survey and give us their ideas by December 15. We will then sit down with the self-regulatory agencies to assess the recommendations and see what can be done to implement them.

For this industry to realize its potential, to provide the service investors need in these times, to mobilize the capital needed to provide jobs and progress, we must resolve the questions which now complicate planning and building for the future. Here we have an industry, one at the heart of the capitalist system, which for the first time is having its own equity values set in the public markets. The price-earnings ratios must be embarrassingly low. I don't know exactly what that means. Uncertainty about the future may well be a major factor. I do know that low valuations make it difficult to attract capital and that this in turn can make it difficult to raise the capital our economy needs. I also know that the public has large savings and I believe it is receptive to sound investment guidance. We know that we have an equity market in which the institutions do most of the trading and individuals own most of the shares. I know that your industry has some 50,000 registered representatives serving the securities needs of both institutions and individuals at a commission rate which hovers close to one percent, except for very large and very small transactions,

while 300,000 men sell life insurance at a considerably higher commission and some 12 billion dollars come tumbling into pension funds automatically every year. I believe that the value of your firms will depend on how well you serve and on how soundly you price your services to both individual and institutional investors.

It seems to me that the strength a securities firm can muster to serve the public will depend largely on the scope of its services and the quality and efficiency with which they are provided. A firm can concentrate its talent to specialize or it can assemble the talent to perform a large variety of services, each activity generating experience, strength and talent to help make the others more effective. In our economy, both approaches compete and those who need a particular service select that which pleases them best.

Today, I would like to address the bulk of my remarks to what I regard as the pernicious notion that seems to prevail in some quarters that men can no longer be trusted to adhere to standards of fiduciary obligation or to recognize and deal responsibly with conflicts of interest or to measure the value as well as the cost of what they buy. We run across this notion in demands to separate various functions, to bar

lawyers and underwriters and bankers from boards of directors, to require investment managers to buy the cheapest brokerage service and on and on. Now, there are frequently perfectly good reasons to specialize or concentrate on performing a single business function, or to refrain from serving as a director for a corporation in which one has another relationship or to buy the cheapest service and anyone is free to do so. There are frequently, however, perfectly good reasons to go the other way, and one should recognize that this choice is likely to require greater care and responsibility. I am saying that the choice should remain open, and that the public is frequently better served when men are willing to assume multiple responsibilities and to weigh benefit as well as costs, and that we should not be frightened by nervous lawyers who may try to alarm us, or be intimidated by litigious lawyers who may wait in the wings.

Anglo-Saxon law has relied on the concept of fiduciary obligation to manage conflicts of interest for many centuries. After all, there are only three ways to deal with them. One is by having a policeman or an inspector to watch every one and there have never been enough people for that. The second

is to cut everything up so that no one ever acts in a multiple capacity and there can be no conflicts. No society has ever even thought of working that out. The third way is by self-discipline, of which fiduciary obligation is certainly one of the finest and clearest expressions. In no society has the operation of fiduciary obligation been so fully and effectively implemented as it is by full and open disclosure in the United States today.

Now, these are more than abstract principles for the securities industry today. I believe they are the very foundation and go to the very heart of your need and your opportunity to adapt your services to change and to new public needs, to upgrade the scope and the quality of your services, to professionalize your people and your operations.

Abandonment of reliance on the combination of fiduciary responsibility and disclosure would bring about dismemberment of the industry. Merrill would have to become an underwriter, Lynch become a broker, Pierce become a money manager, Fenner become a dealer and Smith would be left with the overhead.

Just as lethal in another way would be acceptance of the interpretation that fiduciary obligation requires the use of the cheapest brokerage service without consideration of qualitative factors, that a fiduciary can weigh only cost, that balancing cost and benefit is beyond his authority. To accept that interpretation of a fiduciary's obligation would, as I said, strip brokerage service to its bare bones and reverse many years of effort to professionalize, broaden the range and quality and elevate the standards and responsibility of the services and performance which the public can expect from your industry.

In our Policy Statement on the future structure of the securities markets, the Commission reiterated its long-standing concern with the quality of services the industry is rendering to investors. As we approach our goal of a centralized market system, it is more important than ever that investors be assured that we further develop a professional corps of brokers with a capacity for excellence in research and other services.

Now, especially in light of the fact that we have embarked upon a course of introducing competitively determined

rates, at least for certain institutional-sized orders, it is essential that the viability of the process by which research is produced and disseminated and by which innovative and quality services are rendered is not impaired.

Some institutional managers seem to be concerned that in a central market system under competitive commission rates they cannot pay commission fees which compensate for research and other services. To dispel these concerns, we issued a release in May of this year setting forth what we believe the law to be on the general principles that govern the selection of brokers and the payment of competitive commissions by institutional managers. Notwithstanding these pronouncements, I am aware that many institutional managers are still searching for that all-elusive "certainty"--they want to be told what they can do, what they cannot do and, perhaps, what they should do in certain specified situations. In a word, they seek definitive "answers" to the "gray" or uncharted areas--areas for which definitive answers are not available and for which definitive answers may not even be possible.

I must confess that I am sympathetic to these requests. After all, this is one of those areas of the law where hindsight proves to be so effective -- questions concerning appropriate conduct by institutional managers are rarely raised in

advance; they are, of course, raised and resolved after the fact -- subjecting managers to great uncertainty, possible legal liability and monetary damages. But the fact is that this is an area in which generalized standards do and must prevail. The Commission is doing its best to make our view of appropriate guidelines widely know. But the ultimate responsibility for compliance with these standards falls upon the investment managers. We stand ready to help clarify the issues; but is the institutional manager who is being compensated for the exercise of his best judgment in light of prevailing principles and circumstances. While we cannot hope to eliminate those Monday morning quarterbacks who may challenge the honest exercise of investment judgment and discretion when circumstances permit differing conclusions after-the-fact, we can set forth, again, our view of the appropriate tests.

Last May we said:

> /T/he Commission believes that an investment manager should have discretion, in assigning an execution or negotiating the Commission to be paid therefor, to consider the full range and quality of a broker's services which benefit the account under management and need not solicit competitive bids on each transaction. Requiring a manager to seek the lowest possible commission cost

> could interfere with the purpose and obligation of managers to seek best performance by excluding the accounts they manage from information, analysis and service which may be of value to them. An adviser should have the flexibility to select a particular broker if the broker selected provides bona fide investment research or other services which he believes are valuable to the beneficiary's interest if he believes the broker can properly execute the transaction. Similarly, the adviser should have discretion to pay a commission rate that will assure reliability and quality of service provided that it is reasonable."

There is a tendency for some to judge a manager's performance of his duty solely by whether the total dollar cost paid for the purchase of a particular security was the lowest possible or, conversely, in the case of sales, whether the net proceeds received were the highest available. It is true that a manager has an obligation to execute securities transactions for his beneficiaries in such a manner that the total cost or net proceeds in each transaction is the most favorable under all of the circumstances. But in stating this principle we should not lose sight of the fact that the cost or proceeds of every securities transaction

is divisible into two component parts: the price paid or received for the security and the brokerage commission paid. Whether the total cost or net proceeds in each transaction is the most favorable under all of the circumstances should not be determined simply by netting these two dollar amounts. The Commission has always emphasized a manager's duty to obtain the best "security price," and that requires no elaboration. However, the value received by the fund and its beneficiaries for the commission paid can and does vary.

Brokerage is, and should be viewed as, a professional service. As with other professional services, it is available in varying degrees of quality. I believe, as stated in our release, that an investment manager should have broad discretion, in assigning an execution or negotiating the commission to be paid for such an execution, to consider the full range and quality of a broker's services which benefit the account under management. For example, a responsible, experienced broker is able to provide his customer with one or more services such as the benefits of experienced traders, constantly in touch with the prevailing buying and selling interest in a multitude of

securities; a well-trained research staff with continually informed views on particular stocks and industries as well as the market and economy in general; an efficient operations department which can be relied upon for secure custody and prompt delivery of funds and securities; a reputation for reliability; the ability and willingness to put capital at risk; and the intangible elements of skill and judgment that distinguish the highly refined and honed traits of the professional from the neophyte or "bargain-basement" operative in all fields of endeavor. All of these, in my view, should be considered when a fund manager selects either a broker who posts a rate schedule north of zero and sticks to it or who, by reputation, negotiates higher rates.

Thus, I do not believe that it is appropriate to require an institutional manager to predicate his execution decisions solely upon the factor of the lowest possible commission cost. While, in some instances, this may be appropriate, requiring a manager to seek only the lowest commission cost could interfere with the purpose and obligation of a manager to seek best performance by excluding the accounts he manages from information, analysis and service which may be of value to these accounts.

Investors must have this discretion and flexibility if a broker is ever to be regarded as anything more than an order-taker. Some people see a need to codify these standards into legislation. While I welcome attempts to clarify the existing state of the law in accordance with these principles, the Commission believes the standards and the discretion I have described already reflect and are supported by the prevailing state of the law.

Now I don't want what I have to say to be understood as sanctioning the practice of using portfolio commissions to "pay" for research. It is the Commission's view that that concept and that practice are obsolete. The direction of portfolio business is not a kind of currency to be doled out as a _quid pro quo_ for research alone, no matter how good the research services may be. We believe that institutional managers should not approach the acquisition of research by keeping a tally sheet of the _individual_ recommendations or reports received from various brokers, and then seeking to spread around commission business proportionately. Research should be part of the brokerage function, and the availability of research and knowledge in which an investor is or may be interested is a proper consideration in the selection of a brokerage firm for any transaction and in the commission rate which the firm charges for its services.

Under competitive commissions, research which is not unbundled but offered as part of a broker's service must be viewed as something which enhances the quality of the brokerage service, not as a separate, severable commodity. There are those who advocate a severance--which is the concept of so-called "unbundling--as appropriate for a competitive rate system. As I have had an opportunity to remark on other occasions, I do not dispute that it is perfectly all right for those who want to sell and buy research for hard cash, to do so. But to <u>mandate</u> the separation of research and brokerage strikes me as quite unnecessary and impractical and harmful. It is doubtful that voluntary unbundling would make any significant contribution to maintaining the professionalism, the quality or the research content of brokerage services.

Some will ask whether our views imply that a manager can pay a higher commission on a particular trade solely to compensate for past research. To ask this question is to miss the point. The higher commission paid in such a circumstance could never be justified merely because it is paid in exchange for a particular "piece" or quantum of past research. "Historical" research can be "rewarded" -- if I may employ current jargon. But it should be "rewarded" in the sense that bona fide previous research can lead a manager to conclude that he is dealing with a respectable, reliable and con-

scientious broker capable and desirous of providing high quality, thoroughly professional brokerage services, not only on the holding acquired in the transaction but on other present holdings and possible future holdings as well. A manager certainly may and should take these factors into account in selecting a broker and determining, negotiating and paying what is an appropriate commission rate.

We also have been asked what, if any, qualitative considerations are appropriate where a manager is not interested in receiving research services. First, I should note that many who ask this question are under the mistaken impression that a fund adviser who takes a money management fee thereby automatically incurs an obligation to provide all of the fund's necessary research. This, of course, is not so, absent a specific contractual undertaking to do so. It is true that the fund adviser does incur an obligation to make the necessary investment decisions and to do so in a sound and knowledgeable manner. This means that the adviser will rely on a research function. But, as we have attempted to make clear, it takes skill and judgment to evaluate research; since a money manager cannot possibly hope himself to perform or acquire all the research he may need, his research function necessarily consists to a significant degree of evaluating and using or discarding the research which others make available to him.

In any event, the fact that a manager is not interested in research in the context of a given transaction does not necessarily mean he is required to pay the lowest commission charge available. As I have indicated today, although research is an important element of professional brokerage services, there is more to brokerage services than research. Execution skill, willingness to position, reliability, availability in the future, ability and dependability in following the stock acquired, reliable clearance and custody of securities--these are some of the considerations which can lead to a decision to select a particular broker and pay him his commission fee, even if it is not the lowest available. It is difficult to conceive of a situation in which a manager appropriately would ignore completely all of these qualitative factors.

I believe it is also worth noting that the whole issue of most favorable price or best execution is obfuscated by the realities of the block market. One does not obtain best execution in the block market by shopping the purchase or sale of large blocks of stock. Customarily, either of two basic techniques is used. One involves the institution remaining passive--that is, awaiting a bid or an offer from a broker representing a buyer or a seller of a large block. In the

second situation the institution determines to be an active seller or buyer rather than to await bids or offers in size. In this situation a seller will request a broker with institutional capability to solicit indications of interest on the other side. Or, the seller may request the institutional broker to make a firm bid and if this is done the broker is simultaneously soliciting buying interest at or above the bid price. With either technique, the block probably will have been shopped in the marketplace. Therefore, it is not feasible to utilize different brokers to ascertain the best price for the security. The knowledgeability and skill of the broker must be such that he can as quickly and thoroughly as possible locate large buying interest in that stock at or about the price desired by the selling institution.

The mere fact that a broker posts very low commission charges is no evidence that he is qualified quickly and satisfactorily to place the block. Despite his bargain basement posted rates, if he shops the block unsuccessfully, the result will be that institutions and other market professionals

will know a block is overhanging the market. This will probably depress the market price and the selling institution will end up either getting a worse price or having to delay, perhaps for a considerable time, its decision to sell the stock. Of course, the converse is true for an institution interested in purchasing a large block of securities.

It seems to me that, based upon the realities of the block marketplace, the diligence and best judgment of the fund manager in its selection of portfolio brokers must be relied upon to protect the interests of the beneficiaries in the fund. Of course, this is not to be confused with the situation where best judgment is not exercised and there is a plan or device implemented which is calculated not to obtain the best price. Similarly, the fund manager most often relies upon the best judgment and expertise of the broker, a reliance directly related to the negotiation of the commission charge.

I recently had occasion to correspond with a small broker-dealer who was under the impression that institutions would not give him portfolio brokerage no matter how exciting his ideas or research efforts because of two reasons. First, he is a fund dealer and, second, he does not have his own execution capability for stock exchange transactions.

I think it once again important to speak out and reassert that in asking the NASD to adopt a rule prohibiting reciprocal sales practices we at the Commission made clear that we were not requesting that fund sellers be prohibited from receiving fund portfolio brokerage. It was and is our view that broker-dealers should seek and be given mutual fund portfolio brokerage on the basis of the value and quality of their brokerage services rather than on the basis of their sale of fund shares.

Somehow an impression has been created in some quarters that the Commission's speaking out against reciprocal practices dealing with the use of portfolio brokerage to reward fund sellers for fund sales, as we did in our Policy Statement, would have the effect of favoring large broker-dealer firms over small and New York City-based firms over those headquartered in Nebraska, Texas or Oregon. That is not the case.

In this age of near instantaneous communication there is no reason why brokers located outside of cities where exchanges are situated cannot obtain the required best execution for institutional orders on such exchanges. Institutions have properly found that one perfectly satisfactory means of obtaining best execution on exchanges of orders that do not require special block capability is to utilize the services of out-of-town brokers who have a well-regarded correspondent in the city where the exchange is located. Direct wires to these correspondents enable the out-of-town brokers to obtain an exchange execution of such orders virtually as quickly and as effectively as if they were sending the order to an exchange floor broker associated with their own firm.

For years out-of-town members of stock exchanges thus have been able to give best execution to institutional customers through their correspondents. We believe no less can be said for the ability of non-exchange member broker-dealers to obtain the same degree of excellence in execution through member firms who now are permitted to be their correspondents under the non-member 40 percent access rules adopted at the behest of this Commission. Under exchange

rules members may agree to permit non-member correspondents to introduce institutional customers' accounts on a fully disclosed basis in connection with the 40 percent non-member access. Thus, even small broker-dealers who do not have substantial amounts of capital at their disposal can compete with the excellence of services they offer.

Brokerage firms based outside of New York City--small as well as large brokerage firms and now non-member firms as well as exchange members--can compete with firms headquartered in New York City for institutional portfolio brokerage. They can do so by offering effectiveness in execution, research, local insights, judgments and services that contribute to the performance of institutions.

The challenge of the developing central market system also offers new horizons to broker-dealers. Large and small brokers, exchange members and non-members and those who presently rely on correspondents as well as those who do their own executing can adapt to it in ways which will maximize their ability to provide brokerage service to institutions as well as other customers. I, for one, believe that this is a very challenging time for the broker-dealer community and I

believe that it is vital that we reject rigidities which would restrict innovation, professionalism, the responsible exercise of discretion and judgment and freedom to compensate when justified by these qualities.

Your industry is in the throes of adapting to competitive commission rates on institutional size trades, to competition in price and size within a central market system, to intensified competition between equity and debt and insurance and real estate instruments, to competition in service and planning between various types of financial institutions. To make these multiple adjustments effectively you must serve the needs and interests of your customers broadly and faithfully. To do this you must avoid conceptual straight-jackets and retain and exercise discretion, judgment, and flexibility to perform for your customers. The Commission wants to shape the rules in a way which protects investors and helps you serve them effectively.