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BITING THE BULLET

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Two weeks ago tomorrow the Commission bit the bullet it had been chewing, to the annoyance and sometimes down right dread, of the securities industry for over six years and announced that it had determined to require all exchanges to eliminate from their constitutions, by-laws and rules all requirements with respect to fixed rates of commission, other than those charged among members, the so-called "intra-member" rates.

The news was greeted with somewhat fewer outcries than we had expected; perhaps all of the emoting and prophecies of dire consequences had occurred before we finally moved and our announcement was more an anti-climax than a surprise. There had been ample hints of the direction in which the Commission was heading and one really would have had to have had his head in the sand or in the stars, or somewhere other than in a position where his ear was to the ground, to have missed the rumblings that had been about for sometime.

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When it was suggested I discuss competitive commission rates today, it may have been with the expectation that more of those hints might be forthcoming, or perhaps that this would be the occasion when the ripened fruit would drop from the tree. Although obviously the fact of the Commission's action makes whatever I say today somewhat less newsworthy or surprising, nonetheless I think the subject is still a worthy one for discussion, since the simple adoption of Rule 19b-3 does not solve all the problems that may flow from this Commission action or terminate discussion of our deed.

I suppose we all know the history of fixed commissions. They show up first officially in the Buttonwood Tree Compact which the members of the then embryonic New York Stock Exchange entered into in 1792, under, as you might guess, a buttonwood tree in the Wall Street area. Under this arrangement the parties agreed that they would all charge the public the same price and would give a preference to each other in their dealings. As other exchanges emerged they all emulated this characteristic of the New York Stock Exchange, down through the Chicago Board Options Exchange which commenced operations in early April of 1973.

Surprisingly, in a nation increasingly caught up since the end of the 19th century in adulation of antitrust concepts, particularly those that declared price-fixing as wrong "per se", no challenge was mounted against this system until the mid-sixties when a suit was brought, not by the antitrust authorities or the Securities and Exchange Commission, but by a private litigant charging that the New York Stock Exchange's fixed commissions violated the Sherman Act. In some measure this lacuna was probably the consequence of the Securities Exchange Act of 1934 which recognized the fact that exchanges fixed rates, but gave the Commission broad authority to monitor their reasonableness.

Only in 1968 did the Commission first suggest that in the context of modern securities markets perhaps fixed commissions were no longer necessary or desirable. This was done in extensive hearings which studied the future structure of securities markets, hearings which continued off and on for three years while the problem of developing a rational basis for a continuation of fixed commissions was addressed at considerable expense and effort,

principally by the New York Stock Exchange. These hearings and the litigation which had been commenced questioning the legality of fixed commissions stirred the interest of the Antitrust Division of the Justice Department which filed with the Commission in the course of those hearings the first of numerous submissions urging with increasing vigor that the Securities Exchange Act of 1934 did not provide any longer, if it ever did, protection for this practice.

These hearings were followed in 1974 with hearings directed to the specific question of whether intra-member rates, i.e., the rates members of exchanges charge for services they perform for each other, should be fixed. Then during the final months of 1974 the Commission held extensive hearings, which resulted in over 2,200 pages of testimony and some 100 supplemental written submissions, concerning the proposal by the Commission that it adopt Rule 19b-3 under the 1934 Act in effect eliminating fixed commissions.

During this entire period the problem was rarely far from the mind of the Commission and its staff. During the period of 1968 to today the Commission took a number of actions related to rates: it held five sets of hearings in response to requests by the New York Stock Exchange to increase rates; in 1968 it caused the institution of volume discounts; in 1971 it caused the unfixing of commissions on transactions over \$500,000, in 1973 on those

over \$300,000 and in 1974 for those under \$2,000; it authorized a surcharge in 1970 pending action on an application for a rate increase; and it secured action by the exchanges granting non-members access to the exchanges on a discount basis.

Since the 1966 filing of the Kaplan case first contesting judicially the legality of fixed commissions, two other actions have been brought raising the same question. One of these is pending in a District Court in Milwaukee, having been remanded for trial by the Court of Appeals for the Seventh Circuit which determined that fixed commissions were not per se legal as a consequence of the 1934 Act and the existence of Commission power to review their reasonableness; and a second is now pending in the Supreme Court on appeal from a determination by the Court of Appeals for the Second Circuit that the 1934 Act and the Commission's oversight have in the past precluded antitrust attack on fixed commissions.

It has not only been the administration, through the Justice Department, the independent regulatory part of the government, through the Commission, and the judiciary which have been probing this problem. Congress has been a vital, and will ultimately be the decisive, force in the resolution of the issue.

In 1971 subcommittees of both the House of Representatives and the Senate commenced extensive hearings on the securities industry, reflecting a concern triggered by the financial crises experienced by the securities industry in 1969 and 1970. Both subcommittees took extensive testimony on the subject of commissions and concluded that they must be abolished. The Senate bill was passed during the last Congress. The House bill, after approval by the Interstate and Foreign Commerce Committee by a vote of thirty-nine to one, was buried in the House Rules Committee by an unusual vote which was the culmination of intensive lobbying by the Securities Industry Association and the New York Stock Exchange. Substantially the same legislation has now been re-introduced in both houses and efforts are being made to expedite the movement of the bills through the legislative process.

In the light of all this it was somewhat amusing, not to say startling, to hear suggestions during the recently concluded hearings on Rule 19b-3 that the Commission avoid acting "hastily", that the Commission had not closely studied the issues, that more time was needed to reach well thought out conclusions, and to read the letter from the Securities Industry Association which warned the Rules Committee of the House against "hasty, last-minute action to adopt this complicated legislation

involving numerous, complex issues." Had the Founding Fathers who met in Philadelphia to frame a constitution moved with the speed suggested by these partisans we would still be under the Articles of Confederation.

I can assure you that the Commission did not mandate this departure from a one hundred and eighty-three year old practice with any pollyanish notion that problems would not flow from it or that theoretical economic considerations were the only justifications necessary. We recognized that with any policy decision of this magnitude, involving a complex industry, complete certainty about its consequences cannot be had. Our responsibility is not to reach an unattainable certainty; it is, to be technical, to be not "arbitrary and capricious." That we have not been; we have been in my estimation judicious, cautious, alert to problems, receptive to the arguments of those who would have preferred a different outcome to our deliberations.

Let me discuss with you some of these problems which I see as flowing from this decision.

First, competitive commissions are going to pose a challenge

to every element of the industry. Old modes of doing business will be obsoleted; for instance, under the shelter of fixed commissions competition among exchange members took the form of competing through quality and quantity of services, rather than through price, a prime means of competition in most industries. This led to "bundling", the combination of various services with that of execution as a means of gaining customer favor. We will, I am sure, see many schemes for unbundling, with separate pricing of various component parts of the bundle.

Various means of pricing services will develop. There may well be some departure from the emphasis upon transaction pricing and more upon pricing related to time periods and minimums based on a specified volume of business. Compensation structures for salesmen will have to be revised. Analyses will have to be made of the costs associated with various services heretofore included for the fixed price.

It may well be that in this "brave new world" some firms will not be able to compete. They will not have the flexibility needed to adjust to the new environment; they will not have the imagination or planning skill necessary to respond to the

developments in the market place. The Commission first indicated on September 13, 1973 that its target for the elimination of fixed commissions was May 1, 1975, thus giving the industry over a year and a half to prepare for the day. Only the other day a veteran of the industry now engaged in rendering consulting services to the securities industry told me that many firms in the industry, including some of the largest, have still to undertake adequate planning for Mayday (the "affectionate" name given May 1, 1975 by those who think it will be just that.) Such news is distressing and undoubtedly it is a harbinger of disaster for those unable to catch up or which lack the resources to stay aboard until they can adjust to the new environment.

It may seem cruel and heartless to say this. If some firms perish, or are compelled to merge or seek some other graceful way out of the industry, it will doubtless be harsh and painful for those whose livelihoods have been tied up with those firms. But this is the relentless price we have always paid in this country for the benefits we have witnessed deriving from fullest competition. It was hard for those associated with the fourteen hundred companies that at one time or another made automobiles

in this country when they failed. It was hard for all the buggy-whip merchants when the automobile began to become epidemic. It is basic to our national mores, and it is documented both by history and the basic realities of economics, that juxtaposed with this cost is great benefit to the public: price competition has been the stimulus for innovation, invention, efficiency and lower prices for the consumer.

It is obvious that the activities of the regional exchanges and the third market will be heavily influenced by this change. Many of the regional exchanges have thrived in a role much different from that which occasioned their origination, the provision of a market for regionally oriented and smaller companies. They became in many instances handy means for institutional investors to avoid the uneconomic characteristics of the fixed commission. In many instances, by relaxing their membership requirements to permit entry by affiliates of institutions, they encouraged various kinds of reciprocal arrangements that permitted recovery for the institutions of amounts approximating the difference between the fixed commission that would have had to be paid for a transaction on the New York Stock Exchange and that which would be negotiated in a price free market. While at least one regional

exchange which did not succumb in significant measure to these devices does not foresee trouble after May 1, other exchanges have expressed concern over their future. I would suggest that many of these suffer from what Chairman Garrett described recently as "The Law of Anticipatory Multiplication": difficulties foreseen are multiplied in prospect well beyond those which actually eventuate (I would suggest a relationship somewhere on the order of ten to one.) Many of the regional exchanges have strengths deriving from the services they provide their members: clearing and settlement; bookkeeping; depository; proximity and ease of transacting. Further, in many instances, by fixing intra-member rates lower than those prevailing in New York, they attract and will continue to attract business. Also, if the Commission were to take measures to heighten awareness of the obligation of brokers to seek "best execution", regional specialists might find themselves considerably strengthened vis-a-vis their NYSE counterparts. In any event, I am confident that the regionals can survive until there is in existence a viable quotation system which will then afford them the fullest opportunity to compete with specialists in the primary markets. With that opportunity coupled with the other advantages

the regional exchanges enjoy, I would suggest that all that can reasonably be done in a competitive economy for them will have been done.

The predictions about the fate of the third market are an interesting example of the diversity of opinion which has characterized the debate about competitive commissions. There are those who have argued that the third market provides in a significant number of instances cheaper execution than that available on the New York Stock Exchange, thus leading to the conclusion that the elimination of fixed commissions will deflect much of the third market's volume back to the exchanges. This is hotly disputed by the New York Stock Exchange which insisted to Congress that it enact legislation requiring that all transactions in listed securities be "exposed" to an exchange market. Without these safeguards, say spokesmen for the New York Stock Exchange, the advent of negotiated commissions will fragment the market and lead to increased third market activity.

Related to this is concern of the New York Stock Exchange that the advent of negotiated commissions will cause the defection of major firms from the Exchange since, in their view, the fixed commission structure and the advantages it affords members is the

glue that holds the Exchange together. They foresee that large firms may "move upstairs", make markets in the stocks most heavily traded, lay off other securities or fragments of the ones they trade through brokers brought cheaply onto the specialist system, and this they say, will destroy the auction market.

I do not share these concerns. Making markets takes capital and most firms can, I think, find more fruitful uses for their capital than market making which, judging by the experience of the last couple of years, is fraught with considerable risk. Furthermore there are considerable advantages for large firms in having a floor execution capacity they can control and direct. I am sure many firms will do cost-benefit analyses to determine the relative economic merits of one course as against another. On that balance, I think they may well find the greatest economic benefit lies in remaining on the Exchange. In addition, I think they will be loathe to give up to their smaller competitors the advantage that has been built up during almost two hundred years in being known as a member of the New York Stock Exchange. Despite the problems of the past, that remains now, perhaps more than ever, a symbol of integrity and eminence; it is an appellation that few will shed lightly.

There is in the concerns of the Exchange, however, some grain of truth. While I would not foresee the major retail firms shedding the exchange, it may well be that some smaller members with limited reliance on retail business may well find it in their interest to forego Exchange membership. This will result in some revenue loss to the Exchange and the removal of these brokers from the presently very effective regulatory reach of the Exchange. The dependence of the Exchange upon membership fees is relatively little and those could easily be made up by adjustments in other sources of revenue. The regulatory problem can probably also be dealt with through a combination of NASD self-regulation and the expansion of Exchange control over transactions accomplished through the facilities of the Exchange by non-members. Any question concerning the Exchange's power to achieve that will be totally removed when the pending legislation is adopted.

One of the most perplexing problems deriving from the elimination of fixed commissions on May 1 is that concerning

research and how it should be paid for. Many securities firms have developed, under the shelter of fixed commissions, extensive research capacity at considerable cost, though recently developed data would indicate the costs of research for even those most committed to it fall short of what many thought they were.

These research efforts have been provided with the proceeds of fixed commissions, although increasingly some such services have been paid for in cash, or "hard dollars", in contrast with the "soft dollars" of commission payments. It is feared that institutions, particularly small and medium sized ones which do not have the income to finance extensive internal research capacity, will after Mayday, because of a fiduciary responsibility to seek out the lowest priced execution, be unable any longer to secure these services with commission dollars. And considering the often specialized nature of the research furnished by securities firms, it is feared that even larger institutions possessing considerable research personnel may be disadvantaged by the removal of soft dollar access to the specialized research firms.

How real this problem is no one knows. It is real that many attorneys for institutions are telling them that after May 1 they may not pay commissions which are explicitly in return for research; thus if straight execution is available for fifty cents a share, a fiduciary could not pay sixty cents a share for execution plus some research benefit.

The problem is a sticky one. The Commission - and Commissioners - have said repeatedly that fiduciaries should not be barred from using commission dollars to purchase services which benefit their beneficiaries, including preeminently research. But, say the conservative members of the bar (and perhaps few members of the bar are more conservative than the counsellors of institutional fiduciaries), Commission pronouncements and Commissioner speeches do not make law - and even if we could influence federal law, many of the problems derive from state law pertaining to fiduciaries over which the Commission has no jurisdiction, either to change, interpret, or abolish.

Both the Senate and the House legislation proposed contain sections addressed to this problem, though they differ significantly in their scope and the extent to which they eradicate the concerns of counsel. Even the House version, which is intended to be more

(In the end, the Senate version more nearly preempted existing fiduciary laws)

protective of fiduciaries, has not stilled the concerns of many fiduciaries and the effort is continuing to provide a greater measure of assurance.

I said that how real the problem is no one knows. Many think that the pricing pattern that emerges will not consist of two prices, one for execution alone and another for execution plus research; rather, these people expect that the differential will be insignificant and that the firm offering research will receive its reward for it by larger volumes of business which, given economies of scale, will provide the resources out of which to pay for a continuing research service. This may well eventuate.

Regardless of what happens with respect to pricing for research, I would suggest that one consequence will be the upgrading of brokerage firm research. I have yet to meet an institutional manager who has not said that a goodly part of the research that emanates from brokerage firms is useless, inferior worth little, if anything, in a market where it would have to compete for hard dollars. Even if the law were clear that commission dollars could be used for research, I would suggest that before a money manager pays the increment related to the research service he will carefully determine whether he is receiving reasonable value for those additional commission

dollars. In the final analysis, if there is an identifiable commission charge for research, the line between "soft" and "hard" dollars is a hard one to limn and the practical consequences in terms of sorting out the good from the bad research will be the same.

These are some of the problems associated with this monumental change in the way our exchange markets do business, but I have by no means exhausted the litany. It is not the intention of the Commission to ignore the manner in which markets operate and the industry functions after May 1. It is not inconceivable that consequences may emerge which are inimical to the public interest, and if they do, I think the Commission must be able to respond quickly and intelligently.

Looking to such a response ability, the Commission is presently developing more sophisticated and timely means of monitoring various data related to markets and the industry and the manner in which they may change as a consequence of the elimination of fixed commissions. For instance, we expect to observe closely the trends in liquidity of listed securities, specialist spreads, volumes in the various markets, patterns of compensation, levels of commissions, and other data. Much of this has been monitored

in the past. We expect to do it more thoroughly and promptly during the critical days after May 1. And we expect to develop plans for dealing with trends consequent upon the onset of competitive commissions which we feel are contrary to the public interest.

The Commission is of the opinion that under present legislation it has ample power to deal with any distortions that may develop after May 1 which are inimical to the public interest. Both the Senate and House versions of the proposed legislation amplify further those powers and should remove from the minds of even the strictest constructionists of Commission power any doubt of its legal capacity to deal with the emerging problems.

A word about intra-member rates. Despite a conclusion that the public interest will be served by the elimination of fixed intra-member rates as well as fixed retail rates, for a number of reasons we postponed the commencement of competitive intra-member rates until May 1, 1976. The problems associated with that move differ significantly from those related to the elimination of fixed retail rates. Furthermore, even if intra-member rates declined under the impact of competition, the amount of any

foreseeable decline would be of relatively small benefit to the public. Finally, it seems to me sensible that we take one bite at a time, observe the manner in which that is digested before taking the second. I personally do not think the arguments for permanently foregoing competitive intra-member rates are persuasive; those for a moderate postponement are. Competitive intra-member rates perhaps more than anything will bring about the modernization of the methods presently used to execute transactions on the floors of exchanges - and that, more than the simple elimination of fixed intra-member rates, will reduce the cost of transactions for members of the public.

I would like to think that the issue is now settled once and for all - and it may be unless the New York Stock Exchange on the day after tomorrow carries out its threat to meet us on the steps at Foley Square, the location of the Federal District Court in Manhattan. It is often inappropriate for litigants to comment publicly on suits after they are commenced, but I do not think it untoward for a potential defendant in that suit to comment on it before its commencement.

There is every indication that Congress will enact legislation confirming the May 1 elimination of fixed commissions before that date, and if not by then, within very few days

after that time. Everyone, including executives of the New York Stock Exchange, concedes that any hope of a successful legal challenge to thwart fixed rates perishes when President Ford puts his pen to that legislation. Thus any gains from litigation are doomed at best to a short life, with nothing to show for the effort other than a substantial expenditure of funds by an exchange whose budget is already under attack by a substantial portion of its membership and the public spectacle of an ill-starred confrontation between the Commission and the nation's largest exchange.

In 1972, following the recommendation of William McChesney Martin, the New York Stock Exchange with not inconsiderable fanfare expanded the number of "public" directors from three to ten, one short of a majority of its board. It said in its communication to its members concerning the proposed constitutional amendments to accomplish this that the changes would "...make the Exchange more effective in representing the public interest in its policy making." It cited the Committee on Exchange Reorganization in saying that the interests of the Exchange are closely related to those of the public and quoted it as saying that all directors - public and industry - would be "...committed to serving the interests of the public..."

I would suggest that no decision the public directors of the Exchange have been called upon to make since the commencement of their service on that board is as important as the one they will ponder in two days - whether to authorize suit against the Commission to block the onset of competitive commissions on May 1. As The New York Times stated editorially the other day, "This could be the moment for the public directors of the New York Stock Exchange to assert their influence...The outside directors can have little cause to wonder where the public interest lies."

While obviously these directors have the same responsibility that any director has with respect to the entity on whose board he serves, nonetheless they have been represented to the American public as assuring that Exchange policies will be in the public interest. They are now at the moment of truth when the extent of their concern for the public interest, as it is affected by Exchange conduct, is to be tested. It is difficult to visualize this group of distinguished men and women, most of whom have reached their eminence and success by leadership in industries characterized by intense price competition, voting to fight the Securities and Exchange Commission's efforts to bring that same competition into the securities markets. It will indeed be ironic if the head or

former head of a large automobile company, a major retailing organization, a large cosmetics firm, one of our largest diversified companies, among others, having succeeded outstandingly in a price competitive world, now help to hold back the introduction of the Exchange into that world.

I would not presume to suggest to these public directors how they should exercise their discretion. I would only hope that, when the moment comes two days from now to cast their votes on this issue, they will reflect carefully on the meaning of "public interest" and the not accidental inclusion in their title of the word "public". Not by their presence but by their actions can they put flesh on the concept enunciated by the Exchange that the interests of the public would better be protected by the presence on its board of directors in a substantial number drawn from outside the securities industry.

The Commission does not fear litigation. Our lawyers give us sound reason to believe that any litigation seeking to postpone or defeat the onset of negotiated rates will almost surely be futile. None of us has anything personally to gain, win or lose. We are concerned however that such litigation, with all of the drain upon resources it would entail, would seriously hinder the efforts, which should be joint, of the self-regulatory agencies and the Commission to move toward a more sensible and efficient market system.

The securities industry is beset by many problems. These problems will not be resolved in courtrooms. Rather they will be resolved in conference rooms and offices where people of good will representing both the government and the industry seek to reach solutions that serve the public interest.