NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

HOLD FOR RELEASE: 1:00 P.M., EDT

# MAY DAY PLUS FIFTEEN

An Address By

Ray Garrett, Jr., Chairman

Securities and Exchange Commission

May 16, 1975

INVESTMENT COUNSEL ASSOCIATION
OF AMERICA

L'Enfant Plaza Hotel
Washington, D.C.

Greetings on May Day plus 15.

While your attention during this meeting has been drawn to many areas of concern to persons in your profession, and we try to think about these things too, you will understand why, during this particular period, my thoughts do not stray away from May Day for very long. From a broader prospective, it must seem curious that so much excitement and worry could be generated over what brokers charge or receive for their services -- a seemingly incidental element in the total process of capital formation and portfolio management. But we all know the degree to which the entire securities industry has been sustained by fixed commission rates -- the multitude of services offered from the broker's side at "no extra charge"; the services received on the investment manager's side at "no extra expense." Pulling this prop is no little matter.

How does it go? It is tempting to issue a high command sort of advisory that the noble forces of free price competition are vanquishing the evils of sloth and inefficiency, too long nurtured by the protective cover of conspiratorial price-rigging, and that the dawn of a brighter, healthier future is about to break. Like any top command, we would like to keep up the morale of the troops and to keep convincing ourselves of the wisdom of our strategy. But in the confines of this room, I will level with you. We don't know yet who is winning.

After some early jubilation that not everyone had died on the beach, the fog of battle seems to have settled down. We hear scattered cries of anguish and frantic imprecations to do something. We receive directly, and through the press, a multitude of local action reports -- someone over here is down to 50 percent off, someone over there is holding the Goldman line but the pressure is growing, and so on. These bits do not yet amount to a comprehensive picture. An operation like this, once launched, cannot be stopped by blowing the whistle the moment someone thinks he has been hurt. If we ever do anything to revise our strategy, it will only be after the fog lifts, at least enough so that we can see with some clarity who is standing where.

All of us on the Commission have been asked frequently if we are surprised at what has happened, to the extent we know what has happened. We can say that, in general, we are not. Experimentation and confusion were among the few clearly predictable characteristics of the immediate post-May Day period. Beyond that, we protected ourselves against surprise by refusing to indulge in precise prediction. This saturnine indifference to consequences of so radical a move was quite irritating to many in the industry who were most apprehensive. It was bad enough for us to appear heartless -- just because it was not our blood and guts that were being spilled -- but worse for us to appear irresponsible in taking a major step without knowing for certain what was going to happen.

In truth, however, detailed forecasting is simply not possible in matters of this sort. One can only rely on fundamental propositions leading to the conclusion that, in present and foreseeable circumstances, our capital markets and the securities industry and investors, great and small, will be healthier and happier, on the whole, with price competition for brokerage services than without it -- than they would be under continued efforts by the exchanges and the Commission to put rate regulation on a rational basis, a politically sustainable basis, and keep the process responsive to changing conditions. Having faith in the soundness of such a conclusion, as the Oxford preacher said, you put your hand in the hand of God and step out into the darkness.

Had we endeavored to predict more precisely, we would, almost surely, have been wrong, casting unwarranted doubt on the soundness of the basic proposition. I say this in part because most of the major forecasts, or scenarios, as they like to say in Washington, do not appear to be coming to pass.

One of these was the predatory scenario based on the law of the jungle -- that big animals eat little animals. We were told that the big, national broker-dealer firms would drive out the little and regional firms simply by lowering rates and sucking up all the business. At the moment, the indications seem rather to be the other way. The deep discounts we hear about are not being initiated by the bigger firms but by the smaller ones. The small firms may be taking business away from the large ones by under-pricing them. Whether they can and will keep this up, and what the response of the big firms will be, of course, we do not now know.

Another forecast -- the David and Goliath scenario -- was that the large, powerful, institutional investors would negotiate the small and weak brokerage firms right into the ground. Here, again, the indications, so far, are the other way. Discounts are being volunteered by the brokers, and the institutions are responding and, of course, playing one broker off against another.

A third forecast, on the other hand, may be occurring -- namely, that those broker firms relying heavily on research are more vulnerable than others.

All of this, however, is necessarily tentative. It is too soon, and the data is too meager, to justify any conclusions upon which to base regulatory action. When I say this, I know that I raise speculation about what regulatory action we might conceivably contemplate. Am I really saying that we would restore fixed rates?

That, naturally, is one possible regulatory action -- the most drastic and, I should think, the least likely. The proposed legislation that has just come out of conference would preserve our authority to do this, but not forever, unless certain, quite stringent, standards are met. Putting it in summary terms, we will be empowered to restore fixed rates up to November 1, 1976, simply by deciding that that is the best thing to do, and adopting a rule to that effect.

After November 1, 1976, however, we can preserve or restore fixed rates only by finding that fixed rates are the least anti-competitive means of avoiding absolute disaster, and only after new, and perhaps cumbersome, administrative hearings. Possibly, the post-May Day experience will enable us to make such a finding, but at the moment, it seems improbable. In fact, I hate to think of the carnage that would seem necessary to sustain such a finding. With this in mind, a relatively short-term restoration of fixed rates is not likely to seem to be to anyone's long-term benefit.

There are other things we can do to impose some restraint on rate-pricing practices short of restoring fixed rates. I am referring to possible rules governing discriminatory practices, give-ups, kick-backs, pricing below cost, et cetera. It is our intention to stay out of this sort of thing, if possible. But, it may not be possible. In my judgment, if we do anything regarding rates, it will be of this nature rather than re-fixing. But the evidence is not yet in.

Turning to the immediate present, ten trading days is too short a time to support any conclusions. All the work we have done over the last two years on the dynamics of the securities markets have impressed us, once again, with the extreme volatility of our markets. Historically, it has been unrealistic to discuss fundamental trends even by looking at one or two years' experience. And this appears to have been borne out over the last two weeks, as emotional responses have been even more volatile than the markets.

During the first one or two days, it was popular to speak of May Day as a "non-event," and brokers seemed generally pleased that the reductions in commission rates were relatively small. Since then, as you know, complacency has turned either to caution, concern or panic, depending on whom you talk to.

We are establishing a comprehensive monitoring system to assemble organized data on the results of unfixed rates, but no really useful data will start coming in through that process until next month. Meanwhile, the information that we have at this moment is substantially the same as that reported in the press and the services, supplemented by a few private calls and letters.

At the retail level, rates appear not to have changed very much, although there are some examples of the kinds of innovations in services offered to individuals and marketing practices for small orders which we had hoped would occur.

On larger orders, primarily from institutions, there appear to have been deeper cuts than many of us had expected. You have all seen the reports which have suggested that, particularly at the medium-size order level -- say 1,000 to 5,000 shares -- the cuts have been quite large. And a number of brokers seem to be finding that the overall effect of commission cuts in orders of that size is somewhat greater than they would have expected.

Of course, we do not really know what the overall level of rate cuts has been. We have heard the same outside figures that you probably have. One firm publicly went to a flat price of 15 cents a share, which can result in a discount of up to 80 percent from the pre-May Day fixed rate schedule on some transactions. And we received a telegram from one broker stating that it had

> "been requested to accept small institutional orders at 10 cents per share on the threat of losing such business. Obviously, this is far below prime cost and we have refused acceptance, but at least one or more brokers apparently accepted this less than marginal business at a decided loss, creating outrageously unfair competition at any cost."

Not only are these discounts surprisingly large in some instances, but they are also affecting more than aggregate rate revenues. Because some of the deepest discounts have been, and apparently are being, originated by firms not traditionally prominent in institutional trading, there seems to be some diversion of the flow of orders away from familiar channels. The significance of this development is as interesting as it is impossible to ascertain so early in the game.

In a somewhat different vein, some practices involving unique groups of buyers appear to have occurred, which may present serious problems of fairness, if not legality. For example, major groups of overseas banks have reportedly asked that they continue to be charged the former New York Stock Exchange rates and then be given a rebate at the end of the month, based on the rate experience of the United States broker on similar orders.

The supposition is that this will allow these institutions to continue to charge their customers a markup over the old standard rate. If that is true, the practice may well mean that the benefit of any reduction in rates will accrue not to the ultimate customer, but to the foreign financial intermediary. Indeed, we understand it to be the position of Swiss authorities that it would be unlawful for a Swiss bank to pass through the benefits of reductions. We are not sure yet of the extent of any jurisdiction we may have over this sort of thing, but it is not quite what we had in mind when we went to competitive rates.

If it is dangerous to presume to understand what has happened, based on ten days of experience and the random receipt of data, drawing conclusions on what it means would be ten times as dangerous. But it is not necessarily premature to discuss some possibilities as to what may be going on that are of more than transitory significance.

Perhaps the most obvious possibility, although not the one the brokerage industry likes the most, is that what we are seeing may be the free competitive marketplace working as it is supposed to work.

One of our staff members was recently asked what rates we hoped the brokerage industry would receive following the unfixing of rates. He suggested that he would like to answer that with a response which he felt was simplistic, naive, generally unhelpful to businessmen -- as most answers provided by bureaucrats are -- but at the same time profound: that is, that we hoped the brokerage industry would receive commission rates that would provide the industry, in the aggregate, with a competitive, fair return on its necessary capital devoted to the brokerage business.

That statement may well be naive, but it really is what this exercise is all about. This does not mean that we are unmindful of the difficulties in determining whether this result is achieved. Frustrations from unsuccessful efforts to establish the amount of capital, as well as expenses, properly allocable to the brokerage business, before even reaching the question of a fair return, had much to do with our getting out of the rate-fixing business.

Nevertheless, the action we have taken suggests at least that we see no _a priori_ reason why competitive forces cannot work in this service industry as they apparently do in a number of others. Indeed, given all the comlexities of this industry, these forces should do a better job than regulation alone can achieve. We hope, therefore, that life will evolve so that the average return of a successful brokerage firm will be that which allows a competitive return on its capital. At the same time, we would be delighted to see the well-run firm earn considerably more than that.

Incidentally, this variance in rates of return among firms appears to be the pattern which has historically been true. We have made tentative estimates of rates of return on ten categories of brokerage firms recently. We find that, in each category, the return on capital of the top quartile firms is an average of 1.7 times as high as the return on the median firm; conversely, a return on the bottom quartile firm is about one half the return of the median firm.

While this, in general, is what we hope will happen, and what we think is at least possible, there are some considerably more troublesome possibilities. Probably the most widespread, in the eyes of the brokers, is that the rate cuts which are occurring are the result, not of fair, free market forces, but of the existence of excessive power on the part of some buyers.

I earlier observed that, during these first ten days of unfixed rates, the impetus for deep discounts seems to have come more from the brokers than from the institutions, who have been receiving offers they think they cannot refuse. This may not prove to be the long-range pattern, however, and the possibilities of excessive power cannot be said to be disproved as of this time. Theoretical economists speak of "oligopsony," which Webster defines as:

> "A market situation in which each of a limited number of buyers is strong enough to influence the market but not strong enough to ignore the reaction to such influence by his competitors."

Many brokers clearly feel that this definition accurately describes the situation they face with their major institutional customers. To them, the notion of "negotiation," or "seeking a fair level of return through competition," is a joke, because institutional buyers have the power to dictate terms. I am not prepared to state that we accept this conclusion. But, I am prepared to state that we are very concerned with the possibility that it might be true, even though, as I have said, the immediate indications are otherwise.

In my view, if this situation proves to be the case, it could produce one of two results which would not be in the public interest and might call for action on our part.

The first of these is that, in order to obtain an adequate overall return on capital and effort, some brokers might attempt to compensate for the underpayments from one class of their customers by effectively overcharging another class of customers with little market power -- the individual investor. If clearly established, this practice would represent an inequity in the market which we might feel compelled to stop. You will understand that this problem is more subtle than simply whether small trades bear a higher proportionate brokerage fee than large trades, and even whether the small trade for an institutional investor bears a smaller fee than the same trade for an individual.

Rather than attempt to preserve fixed rates for the purpose of causing institutional investors to pay artificially high fees to compensate for artificially low individual fees -- something far easier to grasp in concept than to work out in practice -- we decided in favor of unfixed rates with the expectation that they would enable brokers to charge fees for different services for different customers that would, as nearly as they could ascertain, make all business profitable. Conscious overcharging of small individual customers to compensate for bullying by big customers, albeit difficult to prove, if proven, would surely appear contrary to "the public interest or the interest of investors" -- to use the litany of our laws.

The second possibility, of course, is that, if brokers are forced to serve institutions for inadequate compensation, and if brokers are not able to compensate for underpayments from institutions by obtaining overpayments from individuals, their return on capital will be less than adequate. This could have negative consequences affecting the overall long-term viability of the securities industry, and, thus, the maintenance of an adequate secondary market with related services to meet the needs of institutional, as well as individual, investors and, ultimately, on the nation's ability to raise capital.

At this point it should be evident, and is to thoughtful people, that we are not talking only about the financial welfare of securities brokers. We are concerned equally with the welfare of investors; indeed, that is why we are talking about the welfare of brokers. And it is possible that institutions have either "bargained with ferocity," to paraphrase the New York Times, or gone along with steep reductions in rates, primarily because they have not sufficiently concerned themselves with their own long-term welfare. They may not have thought through the value they receive from brokerage firms with which they deal or given serious consideration to their stake, or more appropriately, their beneficiaries' stake, in preserving that value.

This thesis seems to have been supported by a very interesting study which has recently come to our attention. This study suggested that many institutions really had not thought through what their pricing strategy would be after competitive rates. It was based on interviews and questionnaires responded to by a large number of institutional investors, and it reported that a surprising number of respondents were taking a passive, "wait-and-see" attitude toward competitive rates, and had not pondered in very much depth about the value they receive from brokers, or what services they really need and should reward.

Further, the study concluded that a surprisingly large number of institutions seemed confident they could "go it on their own," in terms of research. As a consequence, many of them did not appear to be very concerned with, or to have thought very much about, the possibility, ~~or consequences~~, of a substantially reduced availability of street research.

The study's authors felt that this attitude might reflect a significant undervaluing of research -- or that substantially more institutions felt they could do without street research than in fact really could. To support this suggestion, the authors provided some interesting, if very simple, mathematics.

They estimated the size of a research staff which, in their view, either a large or medium institution would need to be self-sufficient in terms of research. They then compared the cost of such a staff with the typical management fees and other expenses of money managers, and concluded that the cost of "going it on their own" almost certainly would be impossible for institutions managing aggregate assets of less than $100 million, would be very difficult for institutions managing aggregate assets of less than $250 million and only feasible for that relatively small group of institutions managing aggregate assets exceeding $1 billion.

Interestingly enough, yesterday we received the first post-May Day expression of recognition from the institutional side of this important factor. The senior trust and investment officer of a medium-size, non-financial center bank, called to express concern about the possibility that smaller banks could lose access to outside research if the present rate discount trend continued.

Some industry members have hypothesized that the current decline in rates is a result of businessmen paying less than their best business judgment dictates, less than what they legitimately feel value to be, out of fear that their fiduciary responsibilities require them to pay a "rock-bottom" price. We cannot yet agree that this is the reason for the decline, but if it is, I am disappointed, not to say frustrated. My colleagues and I have stated our view, in a number of speeches, that a fiduciary's responsibility is not to pay the lowest possible price for any service received by his beneficiary, but rather, to act so as to maximize the value his beneficiary receives. If, in the fiduciary's best business judgment, the value received more than offsets an additional payment he has made, he has acted in accordance with his fiduciary responsibility.

The Congress apparently shares the same view, since both Houses of Congress included substantially identical statutory provisions in the pending omnibus securities legislation making it explicit that institutional managers could "pay-up" for research and brokerage services. While we had hoped that this language would become law before May Day, now that the Conferees have agreed on a bill, any price cutting out of fear of unwarranted reprisals by beneficiaries should soon be curtailed.

A number of people have questioned whether it still is appropriate for us, at this point, to have any interest in either commission rate levels specifically, or the economics of the securities industry generally, since we have just gotten out of the rate-making business.

There is a legitimate basis for continuing concern on our part, and it stems, primarily, from our obligation, as stated in the Securities Exchange Act, to insure the maintenance of fair and orderly securities markets. True, this is a very broad and somewhat amorphous standard, but the elements of fair and orderly markets are, perhaps, best defined by common sense and certainly have been given substantive content over the course of the last forty years, since the enactment of the Securities Exchange Act.

Given our right to be concerned, what do we plan to do over the short-term? In large measure, as I already have suggested, it is premature to try to answer this question now. We certainly do not plan any precipitous action. We have, however, had a number of internal discussions on the subject generally, and more particularly, on what actions should prompt what response on our part. Our conclusions in that regard are tempered and strongly influenced by our jointly-held belief that an important responsibility we bear, coincident with the unfixing of rates, is to allow a sufficient period of time in which to understand what is occurring and what has occurred.

Because of our concern that short-term moves can prove misleading, or at least hard to understand, we have implemented an extensive monitoring program. And our recent adoption of Securities Exchange Act Rule 17a-20 will furnish us with monthly information on the revenues and expenses of the 160 firms which make up 82 percent of the revenues of the industry. Hopefully, by monitoring the experiences of these firms, we will obtain an accurate picture of the whole. To guard against distortions from our sample, however, we have also requested 110 brokerage firms, representing a stratified sample of the industry, to furnish us, voluntarily, with information concerning their commission revenues from transactions of various sizes from both institutions and individual customers.

If the statistical information we will receive should fail to provide us with a "qualitative" sense of what is occurring, our plans include interviewing both institutions and brokerage firms in late June or July to supplement our statistics. And we may consider further steps, such as whether to convene a one- or two-day conference, perhaps in late summer or early fall, or whether we should establish an advisory committee to play some role in the analysis and interpretation of the events which have occurred, and the data we will have obtained, since the implementation of unfixed rates.

But we are not the only components of the equation leading to the success of our bold experiment with unfixed rates. You, the purchasers of brokerage and research services, have a fundamental role to play as well. You can insure the success of our efforts by thinking about the "value" you receive for your commission dollars and weighing that in terms of the best interests of your beneficiaries. Your market power is substantial; if it is utilized to drive prices down unconscionably and without bona fide justification, it may also serve to drive out valuable brokerage firms and services.

At some distant point, hopefully, we will all reflect upon these times, and wonder why such a big fuss was raised about unfixed rates. We may laugh about the intensity and nature of some of the concerns that were raised. But in these perilous and uncertain economic times, we cannot afford to be cavalier nor can we facilely dismiss the legitimate concerns and fears of those who must prove our experiment a success or bear the brunt of the consequences of its failure. With your cooperation and the cooperation of the securities industry, we will assure for the future, the continued stability and performance of an important national resource.