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COMMISSION RATES IN THE SECURITIES BUSINESS

An Address By

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Securities and Exchange Commission

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I feel it is particularly timely that I have this opportunity today to address this meeting of the Securities Industry Association. As owners and managers of securities firms, yours is the most direct stake in what is happening in the securities industry. I want you to know that we at the Commission share your concern over the growing evidence of lack of liquidity in the market for many stocks, and the disenchantment of the individual investor. Without a vigorous innovative industry, there can be no strong market system, no real market-making capability in depth, no capital raising mechanism on the scale we know today. So, when we view these problems, when we see them persist, when we sense the feeling of malaise that grips the industry and the equity markets, we at the Commission must be concerned as well.

The current situation also drives home with dramatic force some of the questions we are asking ourselves in Washington and some of the questions we think you should be asking yourselves as well. I would like to discuss some of these fundamental questions with you. Basically, they involve the chronic inability of the industry to put together

and agree on a viable, long-term solution to the commission rate problem. They also involve the tendency of operating costs to continue to rise in this industry in a time when reducing these costs was never more important. In the course of my remarks today I would also like to touch on some of our positions on the major elements of House Bill 5050, introduced by Representative Moss -- which deals with the structure of the market and regulation of the industry.

As all of you know, profitability problems in the industry have accelerated to an alarming degree in 1973. The percentage of NYSE members losing money in January was 35 percent; in February it was 57 percent; in March 46 percent. The aggregate losses reported in the first quarter by these firms totaled more than $70 million. There is little reason to believe April produced much improvement. May remains questionable. The point is, when you measure the rate of loss against the capital base of the industry you realize that this situation cannot continue indefinitely.

Against this background, as you know, the New York Stock Exchange has indicated that it will submit to the Commission in the next few weeks commission proposals with

rate increases aimed at generating more revenue. We have not seen these proposals. I cannot tell you what our response will be. But I can tell you the questions this state of affairs raises in my mind, and I think these questions -- or at least some of them -- should be uppermost in your minds as owners and managers.

Before I develop these thoughts further, I want to say in connection with the commission rate proposals that whatever response we make will be made in as reasonable time as possible. Personally, I believe the rate question has been studied to death, and I don't intend to let the computers run for a year on this one. We will hold public hearings. We will consider the views expressed. And we will get the staff working on the proposals on a concerted basis for submission to the Commission and we will develop a response that will be in the public interest.

But the more important question, in my mind, is whether the leadership of your industry should look for an alternative to the present rate system and the cumbersome and time-consuming process that changing it represents. The difficulty, if not the impossibility, of keeping the rate structure tuned to the economic realities of your business certainly is reason enough to look for a better way.

Since the Securities Exchange Act was adopted in 1934, the NYSE has implemented new rate schedules six times: in 1938, 1942, 1947, 1953, 1958 and 1971. Some of the proposed changes were preceded by cost studies of great duration and expense. Except for 1958, the length of time that elapsed between the proposed change, SEC response and implementation of the final schedule was six months to a year or more. As a matter of fact, in 1958 -- when the commission rate proposals were put into effect prior to actual Commission approval -- revisions were required by the SEC a year later. The most recent example of this process was the rate change which finally came into being in April, 1972. This was preceded by a costly study begun three years earlier, seemingly endless deliberations, a temporary surcharge designed to provide the industry some rate relief in the interim and an additional delay caused by the necessity to get approval from the Price Commission.

Let's take a closer look at the anatomy of this process which finally produces change in the commission rate schedule -- a change which in the most recent case will now require, according to the industry, still another change a little more than a year after it goes into effect. First, we have studies to determine the nature and justification for the proposal. Then public hearings are held. Next comes in-depth analysis of the proposals by the Commission staff to determine the validity of the data, the reasonableness of the rates proposed and the applicability of such subjects of a fair rate of return. Finally, there is the additional lapse between the final determination by the Commission and the implementation of the schedule, a process which also requires membership approval and the industry-wide gearing up of computers, books and records to accommodate the new schedule. I am only half kidding when I say to you that if all of these various steps took the maximum possible amount of time in the case of the forthcoming proposals, we might expect some results as early as 1984. This cumbersome procedure, which often results in a commission schedule which when finally approved no longer reflects the economic conditions in the business, should stimulate people in the industry to develop and propose viable alternatives.

When we look at the nature of the commission rate structure, we find even more reason to look for alternatives. The rate schedule now compensates for a wide and varied melange of services. They include execution of the trade, receipt and delivery of cash and securities, investment advice and research. This list does not include the host of other services less obviously connected to the actual trade: custody of stock or cash, transfer of certificates, collection and delivery of dividends, rights, warrants and proxies for "Street Name" certificates. Now I know some of these services generate revenues in their own right; but the total range of these services has to be measured against their cost.

What about some of the special services? The commission rate can cover such services as installation and monthly payments on a direct wire to an active customer's office; free desk space or office space for customers with active accounts; investment management services for institutional accounts; analytical and statistical service; special research studies of all types; and pricing of institutional portfolios, including daily net asset valuations.

I know all of you are aware that this competition in service cuts into operating margins and profits just as competition in prices would -- perhaps more so. The more services a firm provides, the more susceptible it is to inflationary cost squeezes. It is hard to justify commission rate increases against a background of rising costs that reflect such ancillary services as providing direct lines to customers or free computer time and services. Indeed, why shouldn't these special services be paid for directly and separately?

Now as never before it is time for new approaches and new ideas about the commission problem. Your alternative as an industry is to continue to be in a position of putting out fires -- responding to events instead of shaping them. Personally, I would like to see some long-range thinking developed on paper by the industry toward a solution to the rate question. I would like to see some detailed ideas regarding how the industry would operate in a competitive rate environment. Now I know there are many people who say competitive rates would mean a rise in commissions on smaller orders and this in turn would drive the individual investor further away. At the same time we hear from other people that as long as rates on smaller orders are not remunitive, securities firms have no choice but to concentrate

on larger orders. I think the overriding concern here should be development of a rate system that will provide flexibility to all the firms with all their different business structures -- flexibility in pricing their services and competing for business across the entire range of the investment population.

Indeed, if small orders are a losing proposition, what is the incentive to solicit this business? I like the reply someone in the business was supposed to have made: "Well, we lose a little on each trade but we make it up on volume." What is needed is more rate flexibility, which would require the investor to pay for the services he wants and enable the broker to offer a sliding scale of services with different charges for each.

As to the question of whether commission rates which recover costs on small orders and offer a fair rate of return will drive the individual investor further away from the market, I invite your attention to the market vehicles which have recently caught investor enthusiasm: bond funds, real estate investment trusts and tax shelter partnerships -- all of which typically carry a much higher commission charge or spread than a typical stock exchange transaction. The fact of the matter is that individual investors, like all investors, want to make money and they want services which they feel will enable them to do so.

Flexibility in rate decisions should also be retained at the regulatory level. This is one of the reasons the Commission opposes amendments suggested in the Moss legislation which would establish a set time schedule for complete elimination of fixed commission rates. While we have indicated that we want the breakpoint to be reduced to $100,000 no later than April of 1974, we strongly oppose the set time schedule, not because we necessarily disagree with the substance of its terms. It may be that reductions in the breakpoint would be requested by the Commission even sooner than the timetable requires. But the point is that the Commission's administrative flexibility, its ability to monitor the impact of changes and make adjustments in the public interest is a crucial aspect of any viable and long-range solution to the commission rate problem.

The necessity for this flexibility is well documented. Our decision not to lower the breakpoint from its current $300,000 level in April is a good example. In one of the rare instances when hindsight squares with foresight, the

profitability data for January and February and now March are proving the validity of our premise -- although we would have rather been proved wrong. To lower the break-point when volume was declining, the number of trades decreasing, securities prices falling, and the industry's regulatory and operating costs increasing would have amounted to making a decision despite the facts rather than because of them.

There is another crucial aspect to the problem of profitability, and that is operations costs. These costs continue to rise precipitously and they are crippling the industry. I don't think any solution to the rate question itself will sufficiently address the problems of profitability until operations costs are arrested and cut to a level where they belong. In this connection, I noted with great interest the recent announcement by Shearson Hammill and Harris Upham that they are thinking of combining their order processing and customer accounting operations. It may be that these operational consolidations between firms will offer one approach to this persistent problem.

A really crucial aspect of this problem, of course, is the cost of your mutualized services. The SIA has expressed great concern over this problem, but it persists. For example, look at the present situation in the depositories, an important operational efficiency for the industry. We have the central certificate service of the NYSE. The Pacific Coast Exchange has a depository; so does the Midwest Exchange. The NASD has indicated that it intends to build a depository system. Why not a national depository to integrate or even consolidate these separate operations? That's the real question. Progress here is painfully slow. What is needed is a greater effort by the exchanges and the NASD to resolve their differences and to put together a unified, nonduplicative operation.

Clearing is another example. Virtually all of the major exhanges have their own clearing organizations, along with the NASD. Here again, interface is slow and progress toward an integrated system is minimal, while operational costs continue to mount for the industry.

The central market system is a third example. The Commission's role in this emerging and necessary market

structure will be to create a regulatory framework. Implementing the system and putting together the parts of the composite picture will be up to the industry itself. There has been great concern voiced by the self-regulatory agencies and the firms over the cost of this new communications system, and where this money will come from. But what about existing facilities? What about exploring all of the existing communications networks that exist as a means of welding together the system at as limited a cost as possible.

Legislation comprises still another crucial element of the current picture and I would like to conclude my remarks by touching on some of our positions at the Commission on the major elements of the Moss legislation, House Bill 5050.

As many of you know, H.R. 5050 proposes a solution to the institutional membership issue, an issue which does seem to have been entirely laid to rest by our Rule 19b-2. The Commission in its release briefly set forth its views on the proper use of exchange membership -- in 195 pages and

522 footnotes -- but we have been challenged in the Third Circuit Court of Appeals.

The proposed amendments by the Moss Subcommittee do not differ substantially form the Commission's rule. Our rule seeks to require that a member be engaged principally in a public business and we establish an 80-20 test for compliance. The Moss bill takes the additional step to require a 100-0 test -- a complete segregation of the functions of the broker and the investment adviser for the same institutional account. In determining non-public, or affiliated business, the Commission uses a "control" test and analyzes the facts of specific arrangements to determine whether an actual control relation exists. The Moss bill approach would touch a greater number of relationships by using broad classifications and defining affiliated persons -- specifically all managed institutional accounts. While we maintain that the propriety of our rule includes the advantage of administrative discretion in this area, we nonetheless recognize the prerogative of Congress to seek a definitive, rather than an experimental approach

to these issues. We can thus support the bill as a valid exercise of legislative judgment.

However, we disagree strongly with the linkage in the bill of the institutional membership issue with resolution of the commission rate question. The bill does this by requiring a reduction in the breakpoint to $100,000 on February 1, 1974. Sometime thereafter, if the legislation is adopted in this session, all current members of the exchanges would have to comply with provisions of the "100-0" test.

While the desire of some institutions for membership certainly is closely tied to the level and structure of commission rates, the problems created by these membership go far beyond this issue. In addition, if institutions were to have a free claim to join exchanges to save commission dollars, any program for the phasing-in of commission rates would be academic, at least for business on large orders.

In addition the bill prohibits an Exchange from limiting the number of non-floor members, requires the Commission to take such steps as are within its power to

establish a central market system by February 1, 1975, and certifies SEC power over a central market tape and quotation system.

The bill also prohibits an exchange from preventing its members from trading in the third market, establishes rules of best execution and adjusts the relationship of the Commission to the Exchanges and the NASD to give the Commission more clout in dealing with exchange rules, disciplinary proceedings, net capital requirements for members and a host of other provisions. Our comments on these sections are lengthy and I won't take your time to relate them fully.

The House and the Senate Subcommittees have thus come forward with reports and now legislation which are comprehensive and touch on every aspect of the business you are in. The Commission has set forth its own views, most recently in our Policy Statement on the Structure of the Central Market System. I think it is time now for the industry to use its problem solving talent, and

its innovation to develop positive, far-reaching proposals to resolve the commission question and cut its operations costs by pressing for a greater consolidation and less duplication in the services it shares and finances. This is not the time for you to come to Congress or the Commission and merely criticize the proposals for "reform" which are being discussed. It is time for you to consolidate your efforts, pool your years of experience and professionalism and come to Washington with your own permanent solutions and suggestions to all these issues. It is time for you to tell use what you're <u>for</u>. This is the time for imagination, foresight and cooperation. The future of your industry depends on it.