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THE CENTRAL MARKET SYSTEM AND COMMISSION RATES

An Address By

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Securities and Exchange Commission

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PACIFIC NORTHWEST DISTRICT
SECURITIES INDUSTRY ASSOCIATION

Coeur D'Alene, Idaho

You put a great strain on a visitor from back East. Wednesday afternoon I spent a profitable and pleasant hour with Jack Bookey and his staff in our Seattle Regional Office. This was my first visit to that Office as Chairman, and, prior to it, Jack had been complaining of neglect. It's a pose well cultivated by Seattle Regional Administrators - - a job so burdensome that we have had only three in the 40-year history of the Commission, most of which were filled by the incomparable Jim Newton. The pose, I say, is to affect an air of abuse and inattention while quietly enjoying the peculiar pleasures of being let pretty much alone in a delightful spot. But I want you to know that it's Jack's own fault that I've been deprived of the pleasure of an earlier visit to Seattle - - after all, his tight and effective reign over the regional office has made it exceedingly difficult for me to find an adequate excuse to make the trip out here.

Yesterday, I had a fascinating tour of the Spokane fair. The capital of this Inland Empire has certainly entered an era of new glory. But that excursion, plus another day here in Coeur D'Alene, make it difficult to recall what I came here to worry about, or rather to worry you about.

I would prefer to worry someone into teaching me fly-casting. I have never learned, and some tentative efforts to learn have been near-disastrous. In one of his essays on trout fishing, Herbert Hoover wrote of the fisherman's pecking order. The dry-fly fisherman, he said, looks down on the wet-fly fisherman, who in turn looks down on the spin caster, who scorns the lad with the bamboo pole. Still, he said, all of us, if we are wise, will have a can of worms in a back pocket against the day of desperation. Well, I know all about the worms and days of desperation, but I'd like to get a bit further up the pecking order for starters. I don't like to begin desperate.

When you invited me here, however, I assume you had in mind that I might reflect on a different form of desperation - - that desperation we all share when viewing the current state of the securities markets and, especially, what the federal government is doing to them.

These are not pleasant times. Things are sufficiently depressed, and on such a wide scale, that I hardly know where to begin.

The Dow continues to hit lows we thought we had passed nearly half a decade ago, reflecting, at least to some extent, investor aversion to equity securities.

Corporate offerings of common stock, both primary and secondary, registered with us for cash sale, have fallen off significantly. So much so, in fact, that the cash value of 1973 offerings was less than 50 percent of the cash value of 1972 offerings.

Total corporate offerings have declined substantially over the last year - - from $45 billion to $33 billion - - notwithstanding the heavy demand for capital presently evidenced by the high rate of corporate commercial bank loans and the nearly uniform estimates - - in the trillions of dollars - - of capital needs over the next ten years.

The decline in offerings does not reflect reduced demand for financings; instead it reflects a lack of investor acceptance of corporate securities.

The dramatic decline in share values that we have been witnessing has made it unattractive and, in many cases, impossible, for corporations to raise long-term equity capital, compelling greater reliance on commercial bank loans. And, I needn't mention the effect of that decline in yielding steadily worsening financial results for many of your firms.

While Congress wisely did not expect us at the Commission to concern ourselves directly with maintaining or restoring market prices or securities industry profits, it surely did not expect us to damage them either.

I suppose that is why we are concerned about the criticisms that have been emanating from thoughtful industry spokesmen, such as the address of Robert Baldwin, President of Morgan Stanley & Co., Inc., before the New York Financial Writers' Association on July 31 last.

He notes the extensive losses of New York Stock Exchange member firms - - for the first five months of this year, 222 reporting firms lost $107 million and, even when the profitable firms are included, all 450 reporting member firms lost an aggregate of $20 million for less than one-half year's operations. Things since May, if anything, appear to have worsened.

Mr. Baldwin states that firms showing a profit are, in large measure, and excluding profitable specialist firms, not making their money on traditional securities activities; rather, their income is generated by the interest they are earning on free credit balances, and on stock loan operations.

Where does all this lead?

- - It leads Mr. Baldwin to urge, among other things, a cessation of our program to introduce fully unfixed commission rates by May 1, 1975, and a rethinking of some aspects of our central market system program. He suggests that unfixed rates will substantially increase the likelihood of brokerage firm casualties, which are already numerous. This contraction in available brokerage firms to underwrite equity offerings, in turn, could lead to capital queues by American companies, perhaps precluding some

companies from financing necessary corporate expansion, even when investor demand recovers.

- - It leads John Whitehead, whom you will hear tomorrow, to suggest the need for a new federal agency designed to promote the viability of the securities industry, and also to urge the elimination of our program to unfix commission rates.

- - It leads other responsible industry leaders to question encroachments into more traditional securities activities by banks and foreign-controlled firms. They look at competition from commercial banks as a very serious threat, particularly in view of what they consider to be the more favorable tax treatment and more cooperative, protective, regulation the banks enjoy. They view with great alarm the possibility of free access to our capital markets by foreign-owned securities firms, some of which have now, or have had in the past, direct or indirect financial support from their governments and commercial banks. As you know, we have asked for public comment on these particular questions, and are presently evaluating the responses.

- - It leads some observers to suggest amendments to existing tax regulations in order to stimulate investor demand for securities and enable securities firms to build tax-free reserves during prosperous times in order to offset the drain on this industry during difficult periods, such as the one we face today. We have analyzed various suggestions for amendments to the tax laws and hope to work with the Treasury Department and Congress to support programs which would prove beneficial in the long run to our capital markets.

- - It leads all of us to hope and pray for an end to the depressed and debilitating market prices we have been suffering through long enough.

Not by way of an apology, but as a pragmatic fact of life, however, I think it is important to recognize, at the outset, that the current state of the capital markets is far more likely the result of double-digit inflation and high interest rates, and not the programs for which this Commission is responsible.

Investors seem unwilling to commit themselves to long-term corporate securities, at least as long as they can receive a relatively high, and less risky, rate of return from, among other things, Treasury Department and government-insured securities. During the period from 1971 to 1973, when corporate offerings declined by $12 billion, there was an increase, by over $9 billion, of U.S. government agency securities sold in our capital markets.

But, we are asked, even if the Commission's programs are not contributing factors to the sorry state in which we find our securities markets and the securities industry, why are we pursuing massive reforms and an abolition of the fixed rate system when the industry is so debilitated?

It's not a frivolous question. I sometimes am amazed at the certitude displayed by some persons - - both in and out of government, and in and out of the securities industry - - that the Commission's plans for market restructuring and ending fixed rates are correct, proper and necessary.

I don't want to seem ungrateful for any support we receive. We certainly think our plans are sound, but I freely confess - - perhaps my colleagues may think I confess too freely - - that absolute certitude in this area is intellectually dishonest and pragmatically impossible.

So we at the Commission listen. We all have been listening and we will continue to listen - - to anyone who has a reasonable point of view to express. If at least three of us are persuaded of the inappropriateness (real or potential) of a course of action we have proposed, we can change our focus and direction. This Commission, I am pleased to say, is not afraid to confess error, if error has in fact been committed.

In September of last year, for example, when we announced our general policy conclusions regarding fixed commission rates, we urged a period of limited price competition in the form of, say, up to a 10 percent discount if certain services were not performed for customers. Prior to sending out our more detailed letter explaining the rationale for our several commission rate conclusions, however, a wide spectrum of industry spokesmen and others persuasively argued that our 10 percent discount theory was impractical. As a result, the letter we issued last December reflected our willingness to accept a different, more pragmatic, form of limited price competition, and that was the origin of the unfixing of commission rates on transactions below $2,000.

I cite this example not to congratulate ourselves on effecting unfixed rates for small orders, although I believe that that was a step to be applauded; rather, I cite this experience to congratulate both you and the Commission on working together to implement a program that both satisfied our goals and yet met your concerns. This is the way the system was intended to work and, when it works as planned, everyone benefits.

I'm not trying to persuade you that we will change, or abandon, our present programs. That is not our present intention, although we want our flexibility on major issues to be known and trusted. Nor am I trying to persuade you that we have the <u>right</u> answers to a number of critical problems or infallible foresight. I am more convinced

than ever that there are no “right” answers, and the five of us are not so egotistical as to believe in our own infallibility. While your support for our plans is essential, I think it much more realistic to try to persuade you that we are not trying to punish the securities industry, or destroy its independence and viability, and that we are doing what we are doing because, to us, it seems likely to help.

In the spirit of cooperation and compromise, we expect and welcome constructive criticism. Naturally, we don’t like to be called dirty names, or have our motives impugned, but we collectively have fairly broad shoulders and can take (and, hopefully, responsibly respond to) the industry’s criticism of us as well as we can criticize the industry. It helps, too, if constructive criticism is coupled with constructive and feasible alternatives. Grander visions need not necessarily be abandoned, but it helps us in evaluating our own position if critics tell us not only what they are against, but what they are for, and if what they are for is realistically capable of accomplishment by us within our present legal framework.

All this, I suppose, still leaves unanswered the initial question - - why are we doing all these things, and why <u>now</u>?

For one thing, of course, we aren’t doing it all now. Much of it started back in 1968, when we first began inquiring into the fixed rate structure on exchanges - - albeit, admittedly at a point in time when brokerage firms seemed to many to be too prosperous, unlike today, when they seem to suffer disproportionately. The central market system concept was first enunciated by us in 1971, after our <u>Institutional Investor Study</u> - - a study that commenced in 1968.

Nor have we imposed our proposals on the industry in "cold turkey" fashion. The withdrawal pains threatened to be unnecessarily servere and, perhaps, crippling. Since 1970, we have been phasing out the fixed commission structure - - with a termination date set at May 1, 1975 - - and since 1972, we have been attempting to phase-in a central market system. The full system is still a number of years down the road.

But even measured progress toward an undesirable goal would be undesirable.

Our program of unfixing rates and restructuring the markets is predicated on our desire to introduce greater efficiency in securities transactions and, concomitantly, greater fairness and honesty in our markets - - in good times as well as bad. Those are admittedly broad platitudes and goals. They are not intended to be unduly critical of the industry as it exists and operates today, but only to recognize that improvement is appropriate and possible.

Perhaps investors, and particularly individual investors, won't come back to the equity markets as long as the economic conditions I discussed earlier continue to exist. But if our markets offer them greater liquidity, more price competition, and greater disclosure, we think they will be more receptive to trading in listed securities, even under present conditions. The problems we are trying to solve need solutions in any event. If, in addition to improving market functioning, we also can improve public confidence in those markets, that will redound to everyone's advantage.

Indeed, the steps we are taking should prove directly beneficial to the industry itself. The rigidity built into the present system may have hampered effective and prompt industry responses to industry problems. For example, under a system of exchange-fixed commission rates, firms which find themselves squeezed by rising costs and an outdated

fixed commission rate base, first must persuade the exchanges to request a rate increase; assuming a favorable initial response, the exchanges then must prepare a detailed submission justifying a rate increase, for approval by their Board of Directors. Following all of this, the proposal for a rate increase is then filed with the Commission, public hearings are held, and the Commission spends some time determining whether or not to raise any objection to the proposal. This process is needlessly time-consuming and cumbersome, particularly when you consider that, in a system of unfixed rates, a firm which finds its commission rate charges too low can give itself one-hour service on its request for a rate increase, and the answer will always be yes, subject only to the vicissitudes of market reaction.

But, you may be thinking that the so-called vicissitudes of the market place - - particularly the economic clout of institutional portfolio managers - - necessarily prevent weakened brokerage firms from effectively raising their rates. This is a fear we have heard expressed with growing frequency, particularly since July of this year, where certain firms raised their sales on orders between $2,000 and $300,000 by five percent, across-the-board, but, after several weeks, decided to roll back their increases for their institutional clients.

Notwithstanding our present belief that a system of unfixed rates is viable and appropriate, we want to be responsive to the legitimate concerns expressed by the industry concerning the experiences of these firms in July.

For this reason, and to continue to monitor the industry's experience with other phases of limited price competition, we recently sent members of our staff to visit with

various institutional, retail, regional and research brokerage firms, and institutional investors, including banks, insurance companies and investment companies.

Many brokers told us that their large institutional customers simply refused to pay the higher rate, and directed their business elsewhere. Brokers sometimes were told that the institutions believed they had a fiduciary duty to do so. But, the majority of the institutions we talked to never reached the question whether their fiduciary obligations prohibited them from paying higher commissions to a particular firm for execution. Indeed, it was the opinion of some that they were under no such legal constraints. Instead, the almost unanimous answer, from those institutions that declined to pay higher rates, was that it simply wasn't good business sense to do so.

Does this mean unfixed rates cannot work? On the basis of the information presently available to us, we do not think so.

Look, for example, at the experience of brokerage firms with orders involving over $300,000. Since April, 1971, when the competitive rate breakpoint was first introduced, the average discount from the old minimum rate structure on that portion of an order subject to negotiated rates has steadily and significantly decreased from a high of about 50 percent of the prior fixed rate schedule, while the amount retained by the brokers has steadily increased. By the second quarter of 1973, the average discount had declined to 43 percent, and by the third quarter, to 40 percent. In the last two quarters for which data are available - - the fourth quarter of 1973 and the first quarter of 1974 - - that trend continued. In the fourth quarter of 1973, the average discount from theoretical fixed commissions declined to 37 percent, and in the first quarter of 1974 to 34 percent! And this decline in the average discount, which is itself significant, continued

notwithstanding the 15 percent increase in fixed rates on orders involving between $5,000 and $300,000, adopted during the fourth quarter of 1973.

These data reflect a view that we found to be growing among institutional managers: that the securities industry - - and specifically the execution capability and research that the industry provides - - are essential to the well-being of our capital markets and, therefore, it is not in the best interests of either money managers or their clients to negotiate unreasonably low commission rates. Institutions need and rely upon a healthy and strong brokerage community to enable them to conserve and provide growth for the assets entrusted them by the public.

Institutional money managers realize that they must maintain good relations and active communications with as many imaginative and capable brokerage firms as possible, in order to receive an optimum supply of information, analysis, service and inquiry about available merchandise. Only in this way will they be in a position to seek the best possible investment performance for the needs of their accounts. In this respect, as fiduciaries, they must make decisions based on the long-term, continuing interests of their clients, and not on a short-term, single-trade basis.

The Commission agrees with those money managers who take the view that they are not legally obligated by fiduciary principles to seek the lowest possible commission charge on every transaction. As long as any differences in commissions paid are justified by differences in the quality of services received, a fiduciary, in our view, is free to exercise his judgment consistent with the best interests of his client. To paraphrase Chairman Moss, of the House Subcommittee on Commerce and Finance, fiduciaries are not required to use the cheapest lawyers or the cheapest accountants, and there is no

reason why they should feel compelled to use the cheapest brokers. Rather, money managers should exercise their business judgment and investment expertise to decide what course of conduct, in the long run, year-in and year-out, is in the best interest of their clients. That is how the system should work, even if, at times, that exercise of business judgment produces the result we saw in July.

Moreover, the failure of the attempt to raise rates seems attributable to a number of factors. For one, July was a month of weak demand. Institutions had less business to give out. And, of course, they still had research obligations to satisfy, they continued to do a certain percantage of their business, mostly odd-lots and small lots, in the third market, and they continued to be responsive to the broker-dealers which were initiating trades in securities of interest to their portfolio managers.

In short, while in the process of deciding what to make of the commission rate increases, they had plenty of other demands on their portfolio orders, which in turn was a smaller pool of orders than the average month in 1974.

Similarly, the fact that a great number of firms maintained their rates at the fixed minimum made the upward adjustments that were effected by some firms very conspicuous. With the easy benchmark of exchange-fixed minimum rates, at which many well-capitalized and exceptionally capable execution firms were willing to effect business, a decision to pay the higher rate might have been difficult to rationalize to an irate customer, unless of course the merchandise was not available otherwise or the broker was able to give special service to that customer. Thus, certain institutions decided, it appears, that there simply existed no compelling business reason to funnel orders initiated by the institution to the firms that raised their rates; and they didn't.

On orders above $300,000, where no benchmark exists, the amounts paid by institutions vary considerably. And, as I have indicated, the amount paid and retained by brokers has been steadily increasing.

While we are concerned about the July experience, and intend to continue actively monitoring the rate changes which have been made, to determine their impact and implications, we nevertheless believe that institutions are regaining their long-range vision, and this is a healthy sign to us.

Where does all this leave the industry on the rate question? Has the Commission conclusively made up its mind and turned a deaf ear to any further industry views, comments or experiences?

I started out by telling you that it is not our present intention to waver from our May-day deadline. We think unfixed rates will have to come by then, one way or another. And to have unfixed rates by May 1, 1975, we will have to get started with our procedures fairly soon. But we do not operate by administrative fiat, and we want all of the facts in front of us before we actually take formal action.

This doesn't mean that you should defer plans to accommodate your firm to a system of unfixed rates, in the hope that, like the proverbial damsel, when we say no we really mean yes.

To eliminate some of the confusion that apparently exists about how we will get to a system of unfixed rates, and when we will get started, we issued a release last week that tried to set forth the additional steps that would have to be taken.

The important point that release made was that, unless all the exchanges embrace unfixed rates promptly, we aren't simply going to order them out of existence. We will

hear you and anyone else that thinks we are wrong to go to unfixed rates - - either at all, or by May 1, 1975. And the hearing will not be perfunctory. But we will hear you fairly soon and expeditiously. There now exists a rather lengthy chronicle of the defects in the fixed rate system. It is upon that history that we have predicated our present inclination to effect the elimination of fixed rates. That history is not yet complete, but it will be before we act.

At times, the most depressing aspect of our responsibilities is that we lack the power to effect certain changes we would like to see occur. We are not likely to get the power to reduce inflation, lower interest rates or improve the Dow averages, and that is probably a good thing. But we can correct deficiencies in the present market structure and make these markets more appealing to public investors. That is not a small responsibility and, with your help, we can achieve these goals in the most appropriate fashion.