THE URGENCY FOR AN IMMEDIATE COMMISSION INCREASE

(Statement by Mr. Robert W. Haack before the Securities & Exchange Commission, February 13, 1970.)

Introduction

Four of every ten NYSE member firms doing a public business lost money on security commission income (including net margin interest income) in the first half of 1969. Their cumulative loss amounted to $58 million. Losses ranged up to $5.7 million, with 13 firms losing over $1 million and 51 losing over $250,000. The profit squeeze reflects the industry's attempts to continue to upgrade and modernize operations in the face of a drop in income and sharply rising costs. Prices paid by the industry for the goods and services it buys rose an estimated 6% last year alone, and close to 60% since the last commission rate hike in 1958.

In the face of these financial results, it takes little imagination to foresee that member firms in their effort to minimize losses will have no recourse but to trim the quality of their services to customers, unless revenue relief is forthcoming. Even more adverse to the interests of the investor and to confidence in the securities markets would be the repercussions resulting from financial failure.

Despite their precarious profit situation, NYSE member firms as yet have hesitated to take cost-pruning steps where the effect would be to impair their ability to handle future volume increases. Very much in their minds has also been the risk of a repetition of the 1968 paperwork situation. At present, automation expenditures among NYSE firms are running at a $100 million annual rate. By the end of this decade, they are expected to be approaching $800 million a year.

In 1969, employment associated with security commission income continued to rise despite declining income and profits. Non-sales employment was 84,000 at mid-year, some 5,000 greater than at year-end 1968.

However, even a pickup in volume is not likely to produce reasonable profit levels for a substantial number of member firms with relatively low revenues per ticket. This is indicated by our data on transaction revenues. For example, firms which suffered losses in January-June 1969, would have to increase their aggregate SCI 14% merely to break even -- and this allows for no related increases in costs other than sales commissions, floor brokerage and clearance charges. Only a fraction of the income shortfall could be attributed to the 3% dip in average daily volume between 1968 and the first half of 1969. Even if volume had been sustained at the 1968 level, an income increase of 10.5% would have been required to pull the loss firms up to the break-even point.

Return on Capital

The $80.1 million pre-tax profit earned on SCI in the first half of 1969 translated into the equivalent of a 3.5% annual after-tax return on capital, and even this depressed rate was due to net margin interest income rather than to security commission profits. On the basis of available data for the latter half of 1969, the actual return for the year is even lower.

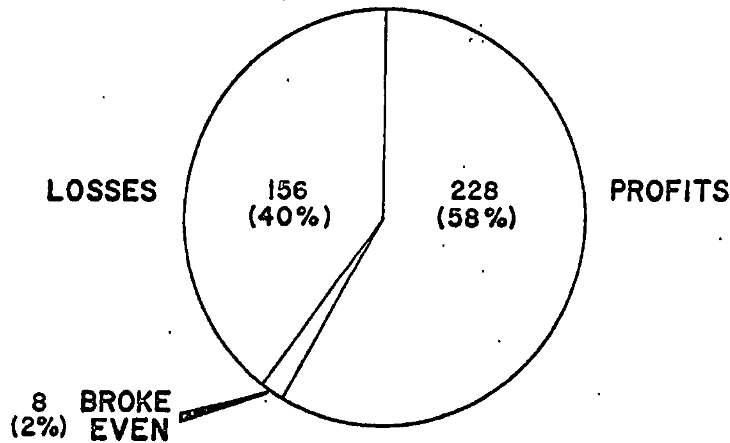
The poor profit performance can be better appreciated in the perspective of recent historical experience in American industry

generally. Analysis of a group of 51 industries representing virtually the whole range of American enterprise indicates an average five-year after-tax return on capital (1964-68) of 12%. (By far the lowest return was for railroads, 4.7%.) Only a quarter of all industries had returns of under 9.8%. (See Appendix I for details.)

Because of the risks in the securities business, a more valid comparison is the return on security commissions with returns in industries in the upper earnings range. As is generally acknowledged, the greater the volatility of annual profits the greater the return necessary to compensate for these risks. Capital will not flow to risk enterprises unless adequately compensated. Analysis of five-year average return on capital shows an upper quartile return of 12.8%. About one-sixth of that group experienced returns in excess of 15%. Two industries experienced returns in excess of 20% -- toiletries and cosmetics (24.4%) and mobile homes (21.2%).

Distribution of Return on Capital -- 1969

The average 3.5% after-tax return on SCI capital in the first half of 1969 understates the urgency of a sizeable segment of the industry for quick rate relief. Of 392 firms analyzed, 156 lost money on their security commission income (including net margin interest income) and eight broke even. Losing firms accounted for 37% of security commission income. (If all lines of business are considered, 117 firms suffered losses -- about one-third of member firms doing a public business.)



Among the 156 firms that experienced losses on SCI income in 1969, fully one-quarter had losses equivalent to over 25% of capital and over one-third had losses in the 11% to 25% range.

Among the 228 firms with SCI profits, about one in four had after-tax profits in excess of 15%, while about one in three had after-tax profits of 5% or less.

Taking all 392 firms together, the proportion with after-tax returns in excess of 15% was only one out of six. At the other end of the scale, the proportion of all firms with losses on their capital in excess of 15% was one out of five. One out of ten firms experienced losses of more than 25% on their invested capital. Obviously, such monumental losses cannot be sustained by any industry for very long.

LOSS OR AFTER-TAX RETURN ON CAPITAL
FIRST-HALF 1969 AT ANNUAL RATES

Profit or Loss Rate (Per cent)	Number of Firms		Proportion of Total Firms (Per cent)	
Losses				
51% & over	14		4%	
-26 - 50	25		7	
-16 - 25	32		8	
- 6 - 15	44		11	
- 1 - 5	41		10	
Total, loss firms		156		40%
Broke even		8		2%
Profits				
1 - 5	83		21	
6 - 15	83		21	
16 - 25	34		8	
26 - 50	14		4	
51% & over	14		4	
Total, profit firms		228		58%
Total, all firms		392		100%

Profitability and Ticket Size

A major factor contributing to profitability, or lack of it, is commission earned per ticket. This shows up clearly in first-half 1969 income and expense data. Firms with pre-tax profits on SCI grossed an average of $56 per transaction, 1.4 times larger than the $40 average for all firms with losses. Particularly striking are the extremes in ticket size among the most profitable firms and those with the largest rates of loss. The ten firms with the largest pre-tax profits as a per cent of SCI (excluding margin interest income) averaged $512 in commissions per transaction. This compares with only a $31 average for the ten firms with the largest relative losses. It is clear that major losses were centered in firms writing the smaller, most frequent types of orders.

In all, 155 firms had commissions per transaction below the $39.69 average for all loss firms. Of that total, seven in ten suffered losses. Conversely, 106 firms had commissions per ticket in excess of the $56.12 average for all profitable firms. Of those, seven in ten made a profit.

These results underline the critical need for prompt enactment of a rate structure which will not only increase overall revenues, but restore balance to the commission schedule -- enabling firms to earn a fair rate of profit no matter where they choose to concentrate their commission business, whether on large or small orders. For most firms, that marketing choice does not exist today. The small order business produces a loss for seventy per cent of the firms engaged in it. As the economic backbone of a major industry, the commission schedule -- in the interests of both investors and the quality of the securities markets themselves -- must restore the incentives to develop and service <u>all</u> orders.

<u>Member Firm Profitability -- Third Quarter</u>

Unfortunately, industry-wide income and expense data are not available beyond the first-half of 1969. However, limited data for the third-quarter are available from Wright Associates, a management consulting firm that does continuing financial analyses for a number of NYSE member firms. (See also Appendix II.)

The data from Wright Associates offer evidence of further deterioration in the industry's bleak profit picture in the third-quarter of 1969. The 16 firms reporting to Wright Associates, together accounting for 22.6% of NYSE business in the third quarter,

had operating losses equivalent to 15% of total income, but before reserves, interest on capital and income taxes. In other words, the sample firms, in effect, paid a subsidy of 15¢ on the revenue dollar for the privilege of serving their customers. Since Wright Associates data are for total income, they probably understate the size of SCI losses and overstate the size of SCI profits.

The third quarter loss virtually wiped out the modest total operating profits that the 16 firms made in the first and second quarters -- respectively, 8.5% and 5.9%. For the first nine months of 1969, profits for this group of large member firms was a minuscule 1.1% of gross income (before reserves, interest on capital and income taxes).

Among the 16 sample firms, only one turned a profit in the third quarter and the median firm had a 14.1% loss on gross income. The largest losses were 23.3%, 32.1%, 53.2%, and 61.5%.

The sample firms' poor 1969 profit performance reflects a relatively rapid increase in break-even points, as firms continued to add to capacity in the face of flagging volume. For example, average daily third-quarter 1969 NYSE volume was off about 5% from the year earlier figure, to 11.4 million shares a day. Over the same period, average break-even NYSE volume for the firms in the Wright Associates sample rose 32%, to 12.7 million shares daily.

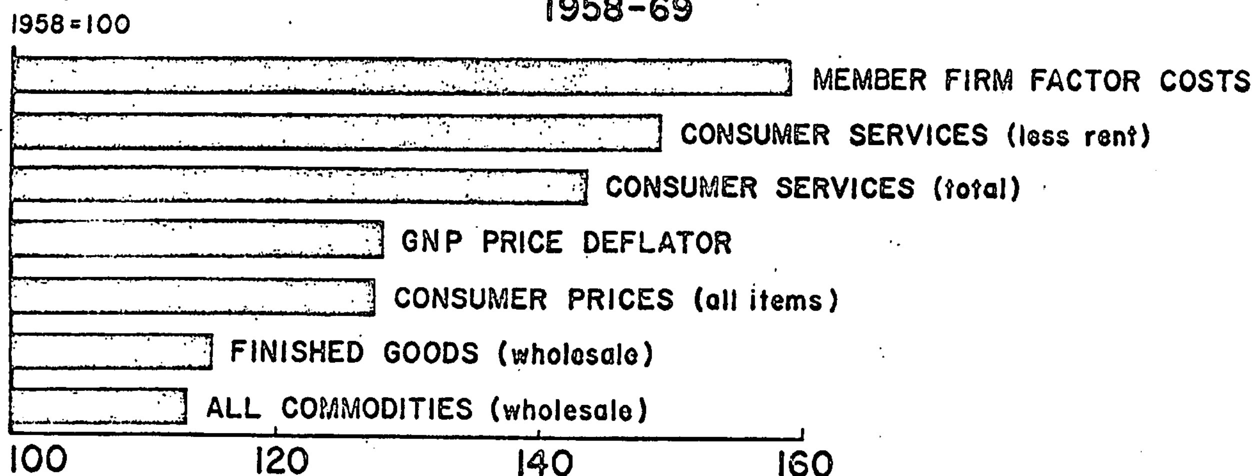
Thus, what would have been a profitable volume level for the sample firms a year earlier -- 11.4 million shares traded daily on the NYSE against a break-even point of 9.6 million shares -- was

completely inadequate in 1969. The gap between the 11.4 million average daily shares traded in the third quarter and the 12.7 million break-even point is reflected in the sizeable third-quarter losses, discussed above. These results graphically illustrate the industry's historic dilemma -- whether to maintain capacity high enough to comfortably handle volume upswings, thereby courting financial difficulty, or to hold capacity close to short-term needs and risk operating difficulties.

Cost Trends

Rising costs of doing business have hit the securities industry particularly hard. One reason appears to be the office boom, especially in New York City, which has intensified competition for space, employees and services. Over the period 1958-69, the weighted average of costs of goods and services purchased by NYSE member firms rose an estimated 59%. This is 4.8 times the increase in the Wholesale Price Index and about 2.2 times that in the overall Consumer Price Index. It is also well above the much publicized climb in the service component of the Consumer Price Index (44%) over the 1958-69 period.

CHANGES IN SELECTED PRICE INDEXES 1958-69



SOURCES: Depts. of Labor & Commerce. Index of member firm costs developed by the NYSE.

A key factor in the strong rise in member firm unit costs is the wage bill. Rates for clerical workers rose, on average, 59% between 1958 and 1969. And this does not include allowance for the widespread introduction -- under competitive labor market conditions -- of new, and improvements in existing, employee benefit programs (a $150 million item in 1969). Manufacturing basic wage rates, by comparison, averaged a 49% increase.

The price of 100 square feet of rental space in 1958, purchased only 52 square feet of space in 1969. Similarly, a dollar spent on advertising in 1969 bought only 55% as much advertising as it did in 1958. The industry's extensive communication network cost 50% more to maintain than a comparable network would have cost in 1958. Comparisons of this type can be made for virtually the entire gamut of goods and services purchased by NYSE member firms, as indicated in the table below.

1969 PURCHASES OF GOODS AND SERVICES
BY NYSE MEMBER FIRMS IN 1958 PRICES

Cost Items	Estimated 1969 Expenses #* (Millions)	% Increase in Unit Costs 1958/1969	1969 Expenses in 1958 Prices (Millions)
Professional Fees	$ 83.2	79%	$ 46.5
Market Information Services	44.0	87	23.5
Subscription to Periodicals	27.9	65	16.9
Telephone and Telegraph	150.0	50	100.0
Advertising and Sales Literature	65.5	82	36.0
Entertainment and Travel	70.0	40	50.0
Equipment Rental	81.1	- 1	81.9
Postage, Stationery and Office Supplies	128.7	61	79.9
Clerical and Administrative Salaries	1,234.8	59	776.6
Other Employee Benefits	150.2	67	89.9
Rent, Heat, Light, etc.	144.2	91	75.5
Leased Wires	38.5	75	22.0
Tickers and Projectors	26.7	85	14.4
Total	$2,244.8		$1,413.1

* * *

WEIGHTED 1969 INDEX OF PRICES PAID BY MEMBER FIRMS, (1958 = 100) -- 159.

\# 1969 expenses are annualized first-half data.

* Data exclude local tax costs since the complete restructuring of New York City taxes in 1966 makes comparisons with prior years impossible. Its basic thrust, however, was to raise the tax burden.

Data also exclude interest costs.

Sources: Budget data from member firm income and expense reports; see Appendix III for sources of data on unit costs.

The lone exception is equipment rental, for which prices fell 1%. For many firms, however, the decline is illusory. It reflects adjustment for quality improvements in equipment, particularly computers -- not lower actual costs per unit.

Commission Rates Versus Other Changes -- 1958-1969

Over the years since the last commission rate adjustment, the seemingly inexorable rise in prices of other services has received prominent monthly attention in all the media. The 49% increase in the services component (excluding rent) of the Consumer Price Index since 1958 is well known. Insurance and finance costs, alone, have risen by over one-third since the end of 1965. Over the same four-year span housekeeping and home maintenance expenses were up about one-third. Two trips to the family doctor or to the barber today cost more than three trips did in 1958.

A current vivid example of how business costs have been pushing against income is the discernible trend among real-estate brokers to boost their commission rates -- despite soaring home prices, upon which the rates are based.* The securities industry has had no such cushion to fall back on. Stock splits serve to hold the average price per share down, so commissions on any given size order

* Wall Street Journal, December 18, 1969, page 1.

benefit relatively little from the long-term rise in stock prices -- and in bad market years actually declines.

This is illustrated in the following table which shows the commission on a 100 share order traded at the average NYSE round-lot price for the designated year.

INCOME PER 100 SHARE TRADE BASED ON THE AVERAGE ROUND-LOT PRICE PER SHARE

Year	Average Price Per 100 Shares	Commission*
1958	3,390	35.95
1959	3,980	38.90
1960	3,700	37.50
1961	3,870	38.35
1962	3,800	38.00
1963	3,910	38.55
1964	3,900	38.50
1965	3,920	38.60
1966	4,360	40.80
1967	4,250	40.25
1968	4,320	40.60
1969	4,040	39.20

* 0.5% of value plus $19.

Because of the relative stability of revenue on any given size order, it becomes increasingly difficult to break even -- much less to make a profit -- on smaller orders. While it is true that the size of securities orders have trended upward, by far the bulk of orders continue to be for 100 shares or less. (While orders of 100 shares or less account for 70% of all orders,

they account for only 21% of shares traded.) Since the larger, more profitable orders are not evenly distributed among member firms, the increase in average ticket size does relatively little to help those firms with a large retail business.

For example, taking all markets together (NYSE, Amex, O-T-C and regionals) the average commission per 100 share order in the first half of 1969 was $30.79. This was less than half the average for all orders, $63.13. Among the 16 large firms for which detailed data are available (23% of NYSE business), average commissions per transaction for all except two came closer to the lower figure than the higher. The average commission was $42.60 and the range was from $37.63 to $50.51.

COMMISSION PER SECURITY AGENCY TRANSACTION
16 LARGE RETAIL FIRMS
FIRST HALF 1969

Firm	Average Commission*	Firm	Average Commission*
1	$37.63	9	$42.76
2	38.18	10	43.14
3	38.30	11	43.84
4	39.49	12	45.21
5	40.22	13	45.43
6	40.49	14	45.48
7	40.69	15	49.19
8	41.12	16	50.51

* Mean of averages for the first and second quarters.

Source: Wright Associates, Management Consultants, New York, N. Y.

For all NYSE member firms that had a loss on SCI business (before margin interest adjustment), the average commission earned on all

transactions was $39.69.

What if Commission Rates Moved in Step with General Price Averages?

The industry's financial plight in 1969 reflects in part, at least, the squeeze between the relatively rapid rise in member firm costs and the stability of its rate schedule.

If commission rates had drifted up each year since 1958 in step with the overall increase in the prices of consumer services (excluding rent), the relatively small annual increments would have lifted the average commission on a 100 share order on the NYSE in 1969 to $53 -- about 50% higher than the actual $35.45 average. How this series of changes, each small in itself, would have mounted over the 1958-69 period is illustrated in the following table.

AVERAGE COMMISSION ON 100 SHARE ORDER OF NYSE STOCK IN 1969 IF RATES INCREASED IN STEP WITH THE CONSUMER PRICE INDEX FOR SERVICES (EXCLUDING RENT)

Year	Commission
1958	$35.45
1959	36.66
1960	38.07
1961	39.00
1962	40.01
1963	40.59
1964	41.48
1965	42.54
1966	44.31
1967	46.47
1968	49.13
1969	52.89
1969 (actual first-half average)	35.45

Sources: Rates of increase based on the Consumer Price Index as reported in the following: Economic Report of the President, 1969 (p. 279) and Economic Indicators, December 1969 (p. 26).

Conclusion

Fragmentary reports of securities firms' third-quarter and fourth-quarter operating results, together with industry-wide data on first-half performance, sketch a dark financial picture of the securities industry. They emphasize the need for quick action on initiating a new commission rate schedule if the meataxe approach to economizing is to be forestalled.

At stake is no less than the industry's financial health, upon which rests its ability to meet efficiently long-term demands of both individual and institutional investors.

APPENDIX I

AFTER-TAX RETURN ON CAPITAL
51 REPRESENTATIVE INDUSTRIES
1964-1968 AVERAGES

Industry	5 Year Average % Profit on Total Capital	Industry	5 Year Average % Profit on Total Capital
Toiletries/Cosmetics	24.40%	Baking	10.70%
Mobile Homes	21.23	Grocery Stores	10.70
Soft Drinks	18.91	Apparel	10.52
Drugs	18.76	Brewing	10.51
Retail-Special Lines	18.41	Conglomerates	10.42
Precision Instruments	17.85	Metals & Mining	10.40
Autos & Trucks	16.05	Petroleum	10.21
Publishing & Advertising	15.24	Milling & Veg. Oil	9.93
Toys & School Supplies	15.15	Packaging & Containers	9.93
Truck & Bus Lines	14.38	Variety Stores	9.92
Personal Services	13.16	Air Transport	9.82
Office Equip./Computer	13.15	Tire & Rubber	9.78
Tobacco	12.69	Distilling	9.67
Machinery	12.48	Railroad Equipment	9.40
Aerospace	12.47	Coal & Uranium	9.23
Household Products	12.39	Textiles	9.11
Metal Fabricating	12.36	Building	9.06
Elect. Equip./Electronics	12.31	Agricultural Equipment	8.32
Recreation	11.74	Paper	8.03
Retail Stores	11.68	Shipping & Shipbuilding	7.88
Auto Parts	11.59	Sugar	7.87
Food Processing	11.58	Steel	7.54
Shoes	11.37	Meat Packing	6.55
Fasteners	11.32	Finance	6.27
Chemicals	11.23	Railroads	4.69
Machine Tools	11.08		

Median	11.08
Mean	11.75
Lower Quartile	9.76
Upper Quartile	12.80
Upper Quartile Average	17.22

Source: The Value Line Investment Survey, Editions 1-13, July-October, 1969.

APPENDIX II

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FOR IMMEDIATE RELEASE

PROFITS OF WALL STREET FIRMS
SHOW A SHARP DECLINE

N.Y., Feb. 3 -- Sixteen brokerage firms that handle a large volume of retail securities business showed a profit of only 1% during the calendar year 1969, according to Wright Associates, a New York management consulting organization. This is 1% before taxes, before reserves and before interest on capital.

The 16 firms, which were not identified, accounted for about 23% of total reported volume on the New York Stock Exchange during the period. Wright regularly makes detailed studies of costs and profitability for these firms.

For all phases of their business, including firm trading, underwriting, investment advisory fees and other items, as well as security commission business, the 16 firms as a group showed a sharp decrease in operating profit from 21% in the year 1968 to 1% in the year 1969.

The third quarter of 1969 was the low point with only one of the 16 firms earning a profit.

The total gross income for the group showed a decline of 15% from 1968 to 1969.

Fixed costs as a percent of gross income increased from 49% for 1968 to 70% for 1969.

Wright Associates is a consulting group who specializes in Financial Planning and Control. Their services include general surveys, design and installation of financial and production control procedures, cost analyses, development of pricing guidelines and strategy, integrated data processing, and other modern methods of reducing administrative overhead. Fifty percent of their volume is in the securities industry.

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APPENDIX III

INDEX OF MEMBER FIRM COSTS SOURCES AND METHODOLOGY

SOURCES:

Professional Fees:

Data obtained from Alexander Grant & Co., an accounting firm, and the Survey of Current Business. Changes in unit costs based on estimated increase in brokerage auditing fees and increase in remuneration per full-time lawyer for the years 1958-1969.

Market Information Services:

Data obtained from Bunker Ramo Corporation. Changes in unit costs based on the estimated cost changes of the Telequote 3 System utilized by member firms.

Subscription to Periodicals:

Based on subscription rates of 21 selected periodicals subscribed to by the NYSE.

Telephone and Telegraph:

Data obtained from AT&T (Long Lines Dept.) and New York Telephone Company (Marketing Dept.). Based on changes in cost of teletype, TWX and telegraph equipment as well as commercial and residential telephone message rates (New York boroughs only).

Advertising and Sales Literature:

Data from NYSE Advertising Department. Based on estimated average increases in unit costs for newspaper advertising and sales literature (labor, paper and ink, and composition).

Entertainment and Travel:

Data obtained from Harris, Kerr and Forrester, an accounting firm, and the Statistical Abstract of the United States. Estimated increase in travel unit costs based on changes in average revenue per air and rail passenger mile; estimated increase in entertainment unit costs based on changes in average daily hotel room rates and changes in hotel meal costs.

Equipment Rental:

Data obtained from U.S. Bureau of Labor Statistics. Based on changes in wholesale prices of office and store machines and equipment, including computers.

Postage, Stationery and Office Supplies:

Data obtained from U.S. Post Office and NYSE Purchasing Department. Based on increases in postal rates (first class, postcards, parcel post and registered mail) and estimated increases in costs of stationery and office supplies.

Clerical Salaries:

Data obtained from Association of Stock Exchange Firms. Based on estimated increase in average weekly clerical salaries for clearing firms (New York offices only).

Other Employee Benefits:

Data obtained from New York State Insurance Department and the Institute of Life Insurance. Changes in unit costs based on increases in average premium payment per $1,000 of insurance for group life insurance and average monthly charges for group medical insurance (Blue Cross and Blue Shield).

Tickers and Projectors:

Data obtained from NYSE Communications Department, ASE Communications Department, Dow-Jones Sales Department, and Trans-Lux Movie Ticker Corporation. Based on increases in minimum monthly changes in the NYSE, ASE and Dow-Jones tickers and Trans-Lux projectors.

Rent, Heat, Light, etc.:

Data obtained from commerical leasing specialists of four major New York real estate firms. Based on estimated increases in average rental per square foot of New York City office space. Costs include air conditioning, heat and electricity.

Leased Wires:

Data obtained from NYSE Communications Department. Based on increase in average monthly stock and bond ticker rates.

METHODOLOGY:

1969 data for each cost item is divided by the relative increase in unit costs since 1958 to arrive at present purchases in 1958 prices. Summation of all deflated cost items gives total 1969 purchases of goods and services in 1958 prices. Dividing actual total 1969 spending by the total in 1958 prices yields a weighted price index for 1969 (1958 = 100).