antitrust

November 22, 1977

MEMORANDUM

TO: J. Richard Zecher
Directorate
Office of Economic and Policy Research

FROM: Harold M. Williams

I have studied your memorandum: Concentration in the Securities Industry. I am less sanguine and have a number of concerns to raise. Your memorandum seems to be saying, by analogy, that since the flood waters have not yet poured over the top of the dam and since there is no past history of their having done so, despite the fact that they are now rising at an unprecedented rate, we have no reason to expect that they will pour over. And you may be right. But what events or rate of change, short of the result itself, would lead you to a different conclusion? Of course, part of my concern relates to 1977 events which were beyond the scope of the study. Would your concerns be heightened by the '77 events?

Particularly with the consolidations occurring in 1977, I see barriers to entry rising very rapidly. I do not see substitutability of other products as providing competitive alternatives. I should note, for example, that while the emergence of the cigarette lighter provided great competition to the match in terms of customers and usefulness, the match industry survived and was very competitive. Indeed, as a result of the cigarette lighter the demand curve for matches was flat, which provided a very important disincentive to entry and encouraged the development of an oligopoly. Has any good research been done recently on the theory of oligopoly?

Indeed, in the securities industry your recitations on the bottom of page three and top of page four underscore for me what it now takes to compete in the industry, the threats to profitability and capital raising that exist and, therefore, the very real rising barriers to entry.

I take no exception to your argument that the increase in concentration attributable to the unfixing of commission rates reflects intensified competition, but with all the massive changes occurring in the industry, not only is competition intensifying, but the game itself is changing as are the rules of the game. Under these circumstances, we cannot look merely to competition, but must look at the effect of that competition, and the evolving game and what does it take to play. It is in that context that your memo seems to me to merely say that once the game has evolved and what it takes to play is apparent, we will report it.

The comparison, for example, to concentration in relation to the banks, I do not find at all useful. To compare statistics between the banking industry which is relatively stable to one which is changing as dramatically as the securities industry, to me, does not serve a terribly useful purpose. Nor, for example, do I understand why it is that levels of concentration become less significant because there are more banks than broker-dealers. Without questioning the desirability of unfixing commission rates, I am also left with the question to what extent enhancing competition, per se, is always or necessarily a desirable purpose or end or at what point price competition between certain industry leaders becomes predatory and anticompetitive to others in the industry. Indeed, I think it may well become important, near term, for us to be able to address that question. Do you have any data or approach that would be helpful?

I have a very serious question as to whether the advent of negotiated rates has enchanced competition in the primary area or may rather have resulted in price-cutting and reduction of profitability which in turn may enhance competition in other activities in an effort to make up for the lost profits. Also, the fact that price-cutting occurs does not necessarily establish that competition has been enhanced.

In part, I imagine the question of the impact on competition depends upon the class of customers. To the extent that the institutional investor is merely looking for execution capability, he will go to the lowest price and may shift brokers on the basis of price. Yet, as far as I understand it, the result has been competitive price-cutting without a high degree of shifting other than indirectly through the acquisition by the major firms of so-called institutional broker-dealers or their merger into major firms which already were or thereby became one of the top ten. As far as retail or public customers are concerned, a somewhat lower commission rate results in a better net price, but what effect does it, or might it, have competitively?

cc: Ralph Ferrara