NEW YORK STOCK EXCHANGE

MEMORANDUM

TO: Mr. G. Keith Funston — May 31, 1963

FROM: A. James Meigs

SUBJECT: Review of SEC Special Study Chapter I

Norman Miller and his staff in the Economic Research Division of the Research and Statistics Department have just completed a careful review of Chapter I. Copies of their four reports are attached. They are to be complimented on their excellent work.

As you remember, four disturbing conclusions about the securities industry and the exchanges could be drawn from the data presented in Chapter I:

1. The dollar volume of trading on exchanges is declining relative to the volume of over-the-counter trading.

2. Trading on exchanges is declining in relative importance as a source of income for broker-dealers.

3. There is a concentration of business in a few large securities firms, as evidenced by Special Study estimates "that about 60 per cent of the gross income from securities transactions of broker-dealers with three or more registered representatives was earned by 5 per cent of the total number of firms (Table I-14)."

4. The compensation scale of the securities industry is "unusually liberal," as evidenced by U.S. Department of Labor data showing that 1961 average earnings were higher in the securities industry than in the other industries covered by the Labor Department series.

The highlights of Norm's findings on each of these main points are presented below. His findings contain abundant material for your testimony in Congressional hearings and also should be of great interest to the general public whenever and however you want to release them.

1. <u>Comparisons of Exchange and OTC dollar trading volumes.</u> (See Miller Report #4 for details.) The dollar volume of OTC trading has <u>not</u> grown significantly faster than exchange volume in the postwar years.

The share of OTC markets in total volume increases in years of high activity but falls off in years of little speculative activity like 1962. Thus the OTC share of total trading volume grew from 31 per cent in 1949 to 38 per cent in 1961. From 1946, an active year, to 1961, however, the OTC share of total trading volume grew only slightly -- from 36 per cent to 38 per cent. Between depressed 1949 and 1962, furthermore, the OTC share grew only from 31 per cent to 32 per cent (NYSE estimate). Incidentally, the NYSE share of total dollar volume rose to 59 per cent in 1962 (NYSE estimate), the highest for any of the postwar years checked (See Table 1, page 3, of Miller Report #4).

In order to confirm the common sense observation that the OTC share of market in 1961 was abnormally high, Norm made estimates of OTC dollar volume for 1959, 1960, and 1962 from New York State transfer tax data. The job was extremely difficult and laborious but was worthwhile. According to these estimates, the OTC market accounted for 33 per cent of total dollar volume in 1959, 34 per cent in 1960, and 32 per cent in 1962, as compared to the 38 per cent for 1961 estimated by the Special Study. These estimates should be a real blockbuster in Hearings testimony on the role of exchanges in the economy, for it is very doubtful that anyone else will have gone to so much trouble checking on the Special Study.

2. <u>Exchange trading as a source of income for broker-dealers</u>. (See Miller Reports #2 and #3 for details.) I had hoped that the Special Study estimates of broker-dealer income would be useful to us for appraising performance of exchange members and the securities industry generally. Unfortunately, examination of the tables and text of Chapter I turned up so many inconsistencies and apparent errors that we just can't base any judgment on the income data. Some of the Special Study estimates were revised after we raised questions (see table attached to Miller Report #2), and there quite likely will be more revisions in the final printed version of the Study. At this point, therefore, we can't say whether exchange trading is increasing or declining in relative importance as a source of broker-dealer income. Even after revisions, furthermore, we won't be able to place much confidence in the quality of the estimates unless we are told much more about the raw data and the Special Study processing methods than we known now.

Some, but by no means all, of the inconsistencies are:

a. In Table 12 NYSE member firms were shown to be earning 19.5 per cent of their gross income from trading corporate bonds. This was later changed to 2.1 per cent.

b. On page 21 of the text, NYSE member firms were said to earn 75 per cent of the industry's total gross income. For the per cent distribution of "All Firms" income in Table 12 to be correct, however, NYSE Members would account for 15 per cent, other exchange members for 23 per cent, and <u>non-exchange members for 62 per cent</u>.

c. Tables 11 and 12 state that 37.4 per cent of the industry's gross income came from mutual fund sales while exchange trading accounted for but 16.3 per cent. The gross error of these estimates can be easily demonstrated. Total mutual fund sales of roughly $3 billion in 1961 could at most have generated about $236 million, assuming an 8 per cent commission. NYSE member firm commissions subject to the 1 per cent charge amounted to $703 million in 1961, a far larger figure.

3. Concentration in the securities industry. (See Miller Report #1 for details.) Even if the Study estimate that 5 per cent of the firms account for 60 per cent of the gross income is accepted, it should be pointed out that such a distribution is not unusual. As Norm found, fewer than 1 per cent of insurance companies account for 60 per cent of total assets (9 companies out of 1,466), and fewer than 2 per cent of commercial banks account for 60 per cent of total deposits (246 out of 13,432). In most industries it would probably be found that there are a great many small firms, some of which specialize in just a few operations, and a smaller number of large integrated firms.

4. Securities industry compensation. (See Miller Report #1 for details.) The relatively high average compensation in the securities industry simply reflects the high proportion of skilled people required for performing securities industry services, as the Study suggests in other sections which discuss the educational and training standards of the industry. Any industry study that purports to make inter-industry comparisons of wages and study that purports to make inter-industry comparisons of wages and salaries certainly should look behind the broad industry averages.

Att.
AJM/aol
cc: Mr. E. C. Gray
Mr. A. B. Chapman
Mr. R. C. Lawrence
Mr. J. A. Brown
Mr. N. C. Miller