

(ADVANCE FOR 6:30 a.m. EST, WEDNESDAY, JANUARY 22, 1969)

REMARKS OF ROBERT W. HAACK
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AT THE
SECOND ANNUAL INSTITUTIONAL INVESTOR CONFERENCE
NEW YORK HILTON
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THE SECURITIES INDUSTRY AND THE REALITIES OF 1969

For our business, you could well say this is the best of times and the worst of times. It has been a year of unprecedented activity...and a year of major headaches. Looking ahead, we can see unmatched opportunities...yet a need for a reappraisal of many basics in our industry. It's a time when we have already made some fundamental changes in our business and it's a time when we shall have to consider more.

We have seen our customers change. We have seen our markets change. I certainly don't have to remind you that volume has changed. When you see single transactions involving 76 million dollars or as many as one million one hundred and fifty-three thousand shares you know things aren't what they used to be.

Change for the sake of change is hardly ever good policy. Yet standing pat is not always good policy either. That certain procedures have worked in the past does not necessarily mean they will work in the future.

What I want to do this morning is refocus on the main issues, speak bluntly about the present realities of our business, the realities of this year 1969, the realities -- whether we like them or not -- of our future.

As analysts, managers, students of the economy and of stocks, we pride ourselves on being hard-nosed people. We spend our hours and earn our money making presumably realistic determinations and

appraisals. We absorb hard details, facts. We pore over the balance sheets and the operating statements and seek the answers to tough questions, weighing objectively the variables and contingencies that can affect our judgments.

But when we turn these disciplines, these skills, these analytical abilities to our own business, I sometimes wonder. Here I do not think we always display the same detachment, the same objectivity. Here we do not always show the same respect for the realities.

Well, what are some of them?

Self-Regulation

You have to start, I think, with reality number one... that this is a regulated business. It's been regulated by the federal government and by itself since 1933 and it's going to go right on being regulated. As it is in banking or almost any other form of financial activity, regulation is a plain, simple fact of our lives, a condition we have to live with.

At this point in time, there is little relevance in debating whether regulation is or is not necessary. What is relevant is that we take a realistic attitude toward the regulated nature of this business.

And when we do, I think we have to grant, first, that regulation has not been unaccompanied by some benefits. The fact is that our business has reached its current vigorous stage partly because of regulation. After the disillusionment of 1929, I seriously question whether public confidence would ever have returned -- as it has -- without the legislation of the early thirties. I can pose the same question to those of you on the mutual

fund side of the street. Your growth, your fantastic growth, during the last three decades from assets of half a billion dollars to nearly \$55 billion today dates from the Investment Company Act of 1940.

Realism demands also that we recognize the importance of our business, its essentiality to the healthy functioning of the economy. Realism demands further that when conditions in this business change, when it is subjected to unusual pressures, it is natural to expect new interest from those responsible for its regulation.

And it is not mere hyperbole to say we have been operating in a pressure cooker for a year or so. Stocks have been traded recently at the rate of 40,000 shares a minute on the Big Board. 25 of the highest volume days in history have occurred within the last ten months. Consider too...as I shall in a minute...the changing texture of our business -- the mounting activity of institutions.

Under present conditions is it unreasonable, unrealistic, that we ourselves re-examine some of our own regulations? For the truth is that ours is not only a regulated business. It is a highly self-regulated business. But only if we continue to show initiative, adjust to change, and revise outmoded procedures -- only under these conditions can we expect to exercise the degree of self-regulation we now enjoy.

Self-regulation must be accompanied by oversight and review. And it must be accompanied by powers of enforcement, including new powers from time to time, such as those recently proposed to our membership. Some people are critical of the new commission structure

with its volume discount and give-up ban. We hear it said that this intrusion on profitability was none of our business, neither the Stock Exchange's business nor the SEC's. But I take a contrary view. I submit it was not only a concern and responsibility of the NYSE, but that oversight review by the SEC is mandated by the 1934 Act. It comprises an important bulwark of our anti-trust immunity.

A number of you have been kind enough to give me your point of view concerning the new commission rates and the ban on give-ups, some in a manner not conducive to making me feel like the "pick of the litter." I submit that these were changes required by new realities. They were responsive to new patterns of transactions and they were responsive to practices that were undermining some business standards of the securities industry.

I further submit that had these erosions and negotiated retentions been allowed to proliferate, the securities industry itself would have precipitated the demise of fixed commission rates.

Role Of Institutions And The Small Investor

Reality number two is something I have already alluded to -- the growing role of institutions in the market. Back in what sometimes seems like another era -- the year 1963 -- the Stock Exchange did not even keep a record of block trading, that is, transactions of 10,000 shares or more. Late in 1964, we did start compiling statistics and, in the last quarter of that year, block trading totaled less than 10 million shares. In the second quarter of 1968, block trading came to 74 million shares, with 68 million in the third quarter, and 100 million in the final quarter.

Lest any of you thinks the full impact of institutional

market activity has already been felt, let me remind you that the life insurance industry, with its 200,000 full-time salesmen, its \$177 billion in assets, is just stepping on stage. Some 175 life insurance companies are now involved in variable annuities or in some form of mutual fund activity. That, of course, is in addition to the growing popularity of other mutual funds and a sharp new orientation toward performance by the men who manage university endowments and corporate pension funds.

If you want a more accurate description of what is bearing down on us, I refer you to a report published by our exchange economist in October. While his predictions as to future volume are expressed in various ranges, consider what might -- let me repeat -- might be some highs -- a possible high day of 40 million shares in 1975...and a possible high day of 63 million shares in 1980.

A realistic attitude about the market of the future demands that we know more about the effect of growing institutional participation. It is not so much the size that is important, but rather the proportion. Four years ago block trading accounted for one share in 35, whereas the proportion today approximates one out of every eight shares traded.

To be realistic about our future we must ask ourselves questions like these:

What happens as public savings become increasingly institutionalized?

What happens to the present balance of individual and institutional investors, and how might this affect market depth and liquidity?

And how much do we really know about the supply and demand

factors in today's market for stocks? We know that the ever-increasing institutional demand for stocks has been met, in recent years, by net liquidations of shareholdings by individual investors. But nothing is known about the characteristics of the individuals who have been doing the liquidating, or their motives.

Hopefully, some of these questions will be answered by the examination of institutional activity now being undertaken by the SEC, an examination to which the New York Stock Exchange has pledged its full cooperation.

Any clear-eyed view of the future must encompass the problems and changes brought on by growing institutional involvement. I think we have to assume that further modification of our procedures will be required. As the current fact-finding effort exposes problems, we must take a flexible attitude toward their solution. Again, we must be prepared to respond to new realities.

There is one aspect of the institutional situation that deserves particular emphasis -- the role of the small investor. Markets in stocks are not made by 50,000-share transactions. It is the continuing stream of smaller trades that creates liquidity. It is thus the individual rather than the institution who is needed to supply depth, liquidity and continuity to the marketplace. As I have said in another forum, I am concerned by the firms -- few in number I'm glad to say -- who have turned away small customers. Ours is a national, an international market, which must serve all investors -- the large and the small, the modest and the affluent, the round-lot and the odd-lot. We cannot withhold or ration our services on a discriminatory basis, or trouble will ensue.

Long-Range Plans

To give optimum service both to small and big investors, our industry is in urgent need of better long-range planning, and more sophisticated management. This is the third of today's realities. This industry is too big, too bound up with the health of the economy, to be run by the seat of its pants. It is too committed to the public interest to tolerate another paperwork crisis such as the one we are presently experiencing.

Some firms, particularly some of the larger brokerage houses, have already taken a leaf from the pages of the corporations whose securities they deal in and absorbed valuable lessons in planning and management. Formalized management, professional management, more modern day management suggests several things. It involves the establishment of some realistic organization goals. And it requires an appraisal of how the realities of the future will affect a particular firm.

As for the Exchange itself, I do not think it is exactly unaware of my very strong feelings on this subject. In little more than a year, our top management has undergone almost total change, not only in terms of organization and realignment of duties, but in method, emphasis and personnel. At the same time, there continues to be some basic restructuring in the organization of key departments.

We have, in the last ten years, invested more than \$40 million in research and automation. The immediate future will require an even greater rate of investment in such activities.

Let me remind you, too, that sometime next month the first phase of Central Certificate Service which is presently processing

about 10,000 trades per day, will be complete. Automated, broker-to-broker delivery of all 1,300 eligible issues listed on the Big Board will be a reality in four to six weeks.

We are also hard at work to implement a Block Automation System designed to respond to the increasing importance of institutional trading in our market. The system would provide a means of matching block trades while assuring participants of anonymity and confidentiality. With any luck at all, we should be able to offer this service around the turn of this year.

The Exchange is also embarking on a program to work with member firms in their long-range planning. We are putting together the building blocks for long-range answers to a number of outstanding industry problems -- including the paperwork problem. Success will depend on the energy with which member firms apply the blueprints to their own business.

In addition to these efforts, we intend to step up our planning services to the securities industry in other respects. For the first time in Exchange history, we will have in 1969 a Public Transaction Study that will cover a whole year's activity. In the past, we have sampled the characteristics of our market for one day, never being sure whether this one-day sample was statistically representative. Now, as part of our effort to promote systematic forward training by member firms, we shall have available a "portrait" of a whole year's public trading rather than a snapshot of one day's transactions.

Groundwork For A New Commission Structure

One of the most important areas for long-range planning obviously concerns the charge we make for our services -- our com-

missions.

A few minutes ago I make reference to the rule changes effective last December. May I remind you that what we voted on was an interim commission structure. Reality number four is that we shall be making in the next twelve or eighteen months one of the most complete studies of commissions ever undertaken, leading to new proposals that will be put to the SEC. This study will have to deal realistically with two factors -- the growing role of institutions and economic impact of new conditions on member firms. At this point, obviously, I can only suggest some of the broader considerations on which this study will be based.

Let me tell you what I can now. We are going to be very conscious, first, that our industry is substantially different from other regulated businesses, such as public utilities. Our firms are subject to an unusually high degree of risk. Consolidated Edison, for example, has a fairly even rate of electrical usage and can predict its demand with a degree of confidence. Our business, by contrast, is highly volatile, subject to very sharp and unpredictable swings in volume. This very real element of risk has to be taken into account in arriving at any appropriate level and structure of commission rates.

We are not deceiving ourselves into believing that it will be easy to define standards. There are very knotty problems to be resolved, including ways of determining profitability. In our business, return on capital is not the only standard of profitability. We will look at other measures of return, including operating margins and returns based upon discounted income and expenses.

Establishing commission rates standards is even more complex than I have indicated. There is a question of determining the scope

of services minimum commission rates should cover, to what extent rates should include services beyond execution and clearance. There is even the more fundamental problem of what this industry consists of -- whether interest is a pertinent item of income and expense, and to what extent underwriting, arbitrage and other brokerage activities are collateral or clearly separable. These basic questions dwarf such mundane but difficult issues of defining statistical income and expenses, of allocating costs, and of relating net income to a proper base for the measurement of profitability. Finally, any level and structure of rates must concern itself with how the rates will affect the future shape of the industry itself.

I should like to stress also that we are not going to try to fix rates for a model brokerage firm. A reasonable, industry-wide average of profitability for commission business appears to be the better approach. This means that if a firm operates efficiently, its profits will be higher than norm. If it operates inefficiently, then its profits will be below average or, possibly, non-existent. Whatever the method employed, it will continue to provide the incentive to operate with maximum efficiency in the public interest.

The study is going to involve a large expenditure of money -- in excess of \$400,000 -- because we need to gather facts and data presently unavailable. We need to have the best possible figures on costs by type of firm and type of transaction, and allocation expenses.

One important element of the study is what we call our Transactions Revenue Survey. In the allocation of execution expenses, we need to know the relationship between orders of various sizes and the number of trades usually associated with these orders. We must

determine, for example, whether a 1,000 share order usually involves two, three, five, or some other number of executions; whether a 50,000 share order requires five, ten, or whatever number of trades. Unfortunately, satisfactory data for determining the relation of trades to orders do not now exist.

The study requires the construction of a scientific sample of all member firm trading in 1969. Each of our member firms will be reporting on its orders and transactions for a two-day period during the year, with different dates assigned to each firm.

I recognize fully that this economic analysis will not toss into our laps a definitive, final and appropriate commission rate schedule. There will still be important policy questions which must be answered, questions which will involve the knowledge, the judgment, and the experience of people in our industry. I can assure you that in determining any new rate structure, we shall make sure that this industry remains strong enough to continue to work in the public interest, to serve, as it has, millions of individual investors, and that it continues to provide a highly attractive investment vehicle by which cash is readily convertible into equities and equities into cash.

Interrelated Questions

Closely linked with the issue of a new commission structure are several other questions you hear frequently raised. What about institutional membership? What about non-member access? What about public ownership. These are serious questions, ones that we are paying a great deal of attention to, examining afresh, in the light of new business realities.

To examine them intelligently, I recommend to you reality number five -- that these questions are interrelated and cannot be resolved on a piecemeal basis. You cannot deal with them as isolated entities. They go together somewhat like a set of gears. Change the shape or size of one, and you have to change them all.

For example, suppose we changed the rules to permit outside financing for brokerage firms. Believe me, this is a very real problem. The device of the subordinated debenture, which is a pending proposal, may prove to be inadequate to the needs of member firms to raise outside capital to finance expansion. It is an issue that we have under very serious consideration.

But if we permit outside ownership, what then is the difference, for our purposes, between a publicly-owned entity which chooses to call itself a brokerage firm, and a publicly-owned entity, also permitted to execute its own transactions, which calls itself a mutual fund? It's a very hard line to draw, and without such a line, the differences between the two types of organizations become largely semantic.

Nor can we deal realistically with the question of non-member access before we deal with the question of institutional membership. How, for example, do you distinguish between the right of a financial institution to execute transactions at the member rates and the rights of a non-member broker-dealer firm to trade for its own account at member rates? Again, the boundary line would be a difficult one to police.

We cannot, of course, really say as yet what the effects might be if we admitted institutions to membership. If, by doing so, we removed this source of income from brokerage firms, would they then be able to continue serving the small, individual investor?

Perhaps institutional membership might institutionalize savings totally, and thereby end the ability of the present, highly-liquid market to absorb large institutional orders, most often without undue price swings. Argued this way, institutional membership may run counter to the interests of the institutions themselves. Hopefully, some indication of the answer may emerge from the studies undertaken by the Exchange and the examination now underway by the SEC.

What we do know is that the questions of non-member access and outside financing for member firms cannot be resolved without facing up to the question of institutional membership. Any approach to these questions individually, separately, is, I submit, simplistic.

To sum up, then, the landscape of the securities industry is characterized by a series of practical realities we must face. A very great opportunity to be of still greater service to the public and the national economy awaits this industry. Our projections indicate the American people are going to have a tremendous appetite for investing in securities in the years ahead. We who are in the securities business will be much better positioned to satisfy that appetite if we acknowledge our problems now and busy ourselves immediately to find the answers.

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