

ASSURING THE ECONOMIC VIABILITY OF THE SECURITIES INDUSTRY

An Address By
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Judging from the telephone calls my Office has received over the last few days, there are a number of cynics extant, who think that I've skipped out of Washington for a period of time, solely or primarily to avoid the aftermath of our historic decision on commission rates.

It just isn't so, anymore than it is true that Lee Pickard, Director of our Division of Market Regulation, is out of the country, and Washington, D. C., until sometime into February, for the same reason. And, I can't understand why some people seem to snicker when I explain to them that our absence s from Washington, at this point in time, are purely coincidental.

Now, it is true, I must confess, that I do appreciate the opportunity to avoid a couple of days of Washington's winter, suddenly grown somewhat colder and more chilly, to talk to a nonsecurities group about matters I think we all can agree are rather pressing and are of a less ephemeral nature than is the subject of commission rates.

I should hasten to add, however, lest the chilling Washington winter should grow any nippier as a result of comments or actions of the industry we regulate, that my reference to this audience as a "nonsecurities" group should not be misconstrued as evidencing any definitive position on my part, or on the Commission's for that matter, with respect to such major questions as the extension or contraction of Glass-Steagall prohibitions on certain banking activities, the broad issues we framed in connection with our bank study, or even with respect to the pending law suit between the New York Stock Exchange and the Comptroller of the Currency over Automatic Investment Service Plans.

And, lest you grow overly concerned about what I might say this morning, I also should point out that, unlike the unwholesome tendencies exhibited by at least one of my more recent predecessors, I am constitutionally not disposed to drop more than one "bombshell" in my speeches for any one fiscal quarter. For that reason, I am not going to announce any new SEC positions on the application of the Federal securities laws to present or proposed activities of banks.

Although, as I have indicated, I tend to view the question of commission rates — or more precisely, the question whether commission rates for exchange transactions should be fixed by the exchanges rather than market forces — as ephemeral, in the sense that the decision, once having been made, will hopefully not have to be continuously reexamined, neither I nor my colleagues on the Commission take lightly the concerns expressed by

many industry representatives, and representatives of other industries as well, over the health and viability of the brokerage community, and, concomitantly, the health of our capital markets and American industrial companies.

This does not mean that our decision concerning the unfixing of commission rates was wrong, or undertaken without conviction, or forced upon us unwillingly. As I have said on other occasions, there really are not "right" or "wrong" answers to questions of market policy. Nor did the five of us lack conviction that our decision to require all exchanges to cease fixing commission rates was an appropriate and necessary conclusion at this time.

To a certain degree, however, I would concede that time and circumstances had combined to force us to reach a conclusion, one way or the other, and, I suppose, ultimately to come out the way we did. But, having required exchanges to unfix commission rates, we at the Commission do not intend to lose sight of the basic economic concerns of the securities industry — concerns that I know you all share, both personally and professionally. The fact that these concerns, in our view, are not demonstrably related to unfixing commission rates does not mean that they are frivolous, or nonexistent.

Brokers having prospered so greatly during some recent periods — although I am sure they do not seem as recent to some as to others — there is a tendency on the part of some people to disregard the indications that brokers today are a more humbled lot than even a vindictive or jealous person had a

right to expect or desire. Others, strangely, seem to rejoice in the fact of brokerage declines, without pausing to consider all the consequences implicit in this newly-acquired, but hardly desired, condition — including consequences touching everyone's life today.

Nevertheless, having participated in the President's economic summit meeting, and one of the mini-summit conferences that preceded it, and having observed another government official who was treated less than courteously when he attempted to tell a mini-summit conference comprised largely of a group of labor officials and public interest representatives how badly off many securities brokers are, I shall not repeat those comments here.

The statistics that we have available to us do confirm, however, that the good old days really were good, especially when compared to modern trends.

For instance:

—the number of brokerage firms has been contracting significantly. Since 1970, there has been more than an 11 percent decline in the total number of brokerage firms doing business;

—the number of New York Stock Exchange member firms carrying public customer accounts has dropped almost 25 percent in the last decade;

—from its high point just two years ago, we estimate that, as of year-end 1974, these 25 percent fewer New York Stock Exchange firms had almost 25 percent lower gross revenues;

—in 7 out of 11 months of 1974, more than half of the New York Stock Exchange member firms doing a public business suffered losses; for 4 of those months an average of 60 percent of these firms lost money;

—in 14 of the last 23 months, more than 50 percent of these firms have lost money;

—for these firms, revenues less expenses through November, 1974, are down to about \$30 million, from \$730 million just two years earlier.

What's worse, since 1972, most sources of income for these trend-setting firms — commission income, underwriting revenues and dealer income — are down significantly, demonstrating dramatically the current malaise our markets are suffering through.

The existence of fixed rates hardly can be blamed for this phenomenon, although, to be sure, some persons tried to make the connection during our lengthy consideration of the fixed rate issue. Thus, for example, in 1969, when fixed rates were still in their full glory, but the public's interest in the securities markets was in a cyclical ebb, as reflected by substantial decreases in both odd-lot and round-lot trading from the prior year, and the major

market index showed about a 15 percent decline in composite values, the industry's return on equity was 60 percent below its median level for the last decade.

The industry has bounced back many times before, and we all hope this is one case where history will continue to repeat itself. Although 1973 was not, to understate matters, a banner year, and much of 1974 followed that trend, substantial improvement did, In fact, occur in the last quarter of 1974, when New York Stock Exchange member firms doing a public business reported profitability levels only slightly below the high levels recorded for the same period two years earlier.

While no one can, and I, in particular, should not attempt to, predict future events, the industry is, in most critical respects, and despite these sharp declines, stronger today than it has been in the past.

For one thing, the capital position of securities firms has improved considerably, and not because firms have been able to raise funds in the equity markets. That has been, and remains a sore point. The companies that went public are faced, to some extent, with investor resentments, resentments which stem in large measure from a misunderstanding of the cyclical nature of the brokerage industry. Some brokers, at least privately, regret their decisions to go public, but many were forced into it, due to the severe capital crunch they faced. Not so privately, other brokers complain that applicable rules, prohibiting them from sponsoring their own securities, have hampered

the development of a meaningful market for their securities, although they recognize the regulatory purposes these rules are designed to serve.

Even without being able to rely on additional equity funds contributed by the public, the quality of firms' capital has continually been upgraded over the last four years, as firms plagued with operational and capital problems merged or were liquidated, and the remaining firms achieved better capital control by limiting the frequency of, and their dependence upon, subordinated borrowings. Our free credit balance and segregation rule, as well as the appearance of SIPC, no doubt helped things too.

Rather than cause the massive catastrophe some have predicted, in fact, the elimination of fixed rates should help some, if not all brokers significantly.

Securities commission income has always comprised the bulk — that is, more than half — of the industry's revenue base. But, as Professor Lorie and others at our most recent round of hearings noted, fixed brokerage rates in the past, have exceeded execution costs. As a result, service competition, in the form of furnishing free, associated, services, became the dominant form of competition. As costs have increased over the last few years, however, and as volume and per share transactional income have decreased, brokers have been locked-in to a fixed rate that no longer reflects economic reality.

Commencing on May 1st, if not before then, I expect that most firms will reconsider their pricing patterns and attempt to package some services for a fair return and unbundle other services, so that nothing valuable is "given away for free." Most firms, for example, tend to agree that brokerage custody of customer securities in street name is far more economic than formal transfer of ownership and delivery. If this is so, after May 1, those customers desiring to take their securities home with them can be charged appropriately.

And, when market conditions so dictate and otherwise permit, brokerage firms will now be free to pass on increased or decreased costs to consumers, without prior regulatory or self-regulatory approval or procedures.

While many brokers cling to the current scheme of things, practical experience would suggest that they long ago should have given up on us and ventured out on their own. A presentation of our rate decisions since 1968, such as the volume discount, commission surcharge and our conclusions on exchanges' rate increase requests, when juxtaposed against industry gross revenues, shows a remarkable inverse relationship between increases or decreases in commission rates, on the one hand, and the trend of revenues thereafter, on the other.

Although some may raise questions of cause-and-effect relations, this fact suggests to me that, under current practice the regulatory lag inherent in the process normally prevents our action from having any meaningful effect, or that, in order to insure regulatory acquiescence on our part, rate proposals

tend to get watered down in the filtration process, to a point where they are incapable, by themselves, of reversing clearly defined, contrary economic trends.

We think these factors should enhance the economic viability of the brokerage industry and place it on a par with other business enterprises, which price their services with regard to their actual costs. This may mean, ultimately, that brokerage services will largely be unbundled, but not necessarily. Given the ingenuity of the securities industry, I am confident that firms will devise service packages in an economic and profitable fashion.

Of course, the advantage of charging separately for services, including research, is subject to the willingness and ability of the customer to pay. This has led to much concern among brokers to whom institutional business as a reward for research is significant. As I remarked in my talk to the Securities Industry Association last month, it is not at all obvious to me that, when commissions come unfixed, a portfolio manager will have an obligation always to seek the lowest execution cost at the expense of drying up his access to street research. Nor does it seem reasonable that he will be obligated to purchase street research with his own hard dollars with no adjustment in his fee.

It may also be that paying up will not be the conspicuous problem that many fear. Everyone apparently agrees that a portfolio manager, even a trust department, can reward a broker for research with greater volume of orders

provided the execution is satisfactory and the execution cost is no higher — just as they do today. So the fears are grounded on the expectation that there will develop, for institutions, a clearly identifiable rate for execution without research and another, higher rate for execution plus research, and that the rate for execution without research will be too low to enable the broker to maintain a research capability.

Maybe this will develop, but maybe it won't. If it does, then for one thing, the aggregate execution expense of managed portfolios will be less than contemplated by the parties when the present arrangements were negotiated, and, at least in theory, the amount by which they are less should generally be available to buy research. But the differential itself may not develop in significant, measurable terms. Some brokers argue that the present cost characteristics of the brokerage business, meaning a higher proportion of fixed costs, are such that they will always benefit from more volume, at least once fixed costs are covered, and that it will be profitable to them to be rewarded for research with more volume without a higher rate for research.

At this juncture, one must say that we cannot predict exactly how it will all work out. I must add that I do not think it is necessary to be able to predict exactly how it will work out. To the extent that street research is valuable, I'm confident that people who can use it will pay for it, one way or another. If it is not valuable, perhaps we have too much of it of too poor quality.

In any event, the Commission probably cannot resolve these questions by formal action under its existing authority. We cannot even resolve them by comfortable words in speeches. Unless the Congress preempts the matter effectively, as H.R. 10 (the old H.R. 5050) proposes to do, the question will remain primarily one of state law governing the duties of fiduciaries. In the absence of clear precedent, the question is one on which reasonable men, including reasonable lawyers, can and do differ. We are beginning, however, to hear reports of a recognition by major portfolio managers that the problem is theirs as well as the brokers and that institutional investors have nothing to gain from drying up access to street research.

Whatever advantages flow from a system of unfixed rates, the securities industry will continue to have to cope with extreme cyclicality. The peaks and troughs of the stock market are directly related to factors beyond our control or the control of the industry — such as inflation, interest rates and the like. It is true that the flexibility that unfixed rates will offer brokerage firms — to adjust their charges for various services to reflect the costs of those services — should help to temper, somewhat, some of the more extreme revenue fluctuations felt by the industry over the years. But, separate charges for research, or transfer of securities, no matter how cleverly computed, will not, and cannot, compensate for severe contractions in securities trading volume, such as the 22 percent decline in New York Stock Exchange reported trades over just the last two years.

This volatility of the securities industry has been well documented by numerous studies. We calculate that, on the average, the securities industry's revenues change at an annual rate of almost 25 percent. Despite continuous efforts to maintain adequate capacity levels, the industry has been characterized by continual contractions and expansion of facilities in order to meet frequent, often abrupt, changes in business and general economic conditions.

The problem generated by these stark facts is not just that the industry must learn to cope with its extreme cyclicity. Insofar as regulatory steps can cushion the effect of these cycles, both the self-regulatory bodies and the Commission have been diligent, as have individual brokerage firms. More important, from our point of view, is the fact that, as a consequence, securities industry capital is costly and scarce, forcing firms — no longer able to rely, as Wall Street once so pervasively did, on old family fortunes — into high leveraging of equity capital, and, consequently, adding even further to industry riskiness.

The significance of all of this to a group of bankers, or nonsecurities industry businessmen, should be getting clearer every day.

The severe contraction in common stock prices — down almost 40 percent in the last 6 years for the average New York Stock Exchange-listed stock — coupled with brokerage revenue declines, have had a depressing effect on the ability of corporations to raise new equity capital. Since 1972,

new common stock offerings have declined almost 62 percent, from \$9.6 billion in the first 11 months of 1972, to \$3.7 billion for a comparable period in 1974. While it may, for the short-run, prove economically rewarding for at least some bankers, no one should take comfort from the fact that, as a result of this lack of equity financing, many companies are highly leveraged and overloaded with short-term and long-term, high interest, loans.

With the notable exception of the railroads, our figures show that, in 1974, liquidity for most nonfinancial companies continued their 1973 decline. Indeed, most aggregate measures of overall corporate liquidity are as low or lower than their previous low points in the depths of the 1969-1970 recession. Much of this economic malaise occurs just at a time when the foreseeable capital needs of American industry are at their highest.

There is little else the Commission can do directly to remedy these problems. We have attempted to keep the securities industry strong, improve its capital base, and we are in the process of supervising the establishment of a central market system to insure continuing and even increased fairness to all market participants, should many of those participants return to the markets.

But even if we lack the power to turn things around by our own efforts, others have more potent weapons at their disposal.

My speech at the Economic Club of New York, last Wednesday night, marked an historic occasion for the Commission, and not just because of our

announcement about unfixed rates. The five of us reached some conclusions about tax policy, and its potential ability to assist in starting back down the road to recovery. Since we have neither the responsibility for, nor any expertise in, national tax policies, our suggestion — that attention be given to the possibility of eliminating the bias in favor of debt financing and low-payouts on stock, by making corporate dividends deductible to the corporation — must be just that, a suggestion.

But, having plunged into the icy waters once, and in view of the demonstrated concern of the Treasury Department for the viability of our capital markets, I for one, at least, believe the Commission should bring its unique perspective to the attention of the Administration's economic and tax policy makers, recognizing, of course, that the ultimate decisions on tax matters are for them and the Congress, and not for us.

While some observers believe the deductibility of dividends will, itself, turn the current bear market bullish, other tax proposals, emanating from persons more knowledgeable than we are, seem likely to help the securities industry improve the adequacy of capital and temper the harsh winds of cyclicity.

In his report to the Secretary of the Treasury, almost one year ago, Professor James Lorie recommended serious consideration of at least two tax proposals that might usefully increase the financial strength of brokerage and investment banking firms.

One of these suggestions relates to Subchapter S of the Internal Revenue Code, which allows certain closely-held corporations to elect to have their income taxed only to their shareholders, whether the income is distributed or not, and to avoid liability for corporate income tax. At the present time, brokerage firms often are unable to qualify for this election, since it does not apply to any corporate taxable year in which more than 20 percent of the corporation's gross receipts are derived from passive investment income — namely dividends, interest and gross receipts from profitable sales of stock or securities. One of the suggestions of the Lorie report is that the Internal Revenue Code be amended so that normal amounts of dividends, interest and receipts from securities transactions would not render brokerage firms ineligible for the so-called Subchapter "S" election.

The report also suggests that consideration be given to exempting brokerage firms from the personal holding company and accumulated earning tax provisions of the Code. Banks, certain insurance companies and finance companies are already exempt from the personal holding company provisions. These provisions, which, under certain circumstances, impose penalty taxes on a corporation's undistributed income, could in some cases apply to a brokerage firm which is organized in corporate form.

The New York Stock Exchange has also made important suggestions in this area. Chief among its concerns is the need for tax reforms to help firms deal with their intense cyclical problems. In that vein, it has proposed that

broker-dealers be permitted to deduct from their annual income certain amounts which would remain untaxed and which would be set aside in a "stabilization reserve fund." Such a fund, which, according to the proposal, would equal up to five percent of the sum of the firm's margin loans, underwriting positions and market-trading positions, would be intended to serve as a cushion against cyclical fluctuations. It has been suggested that such a "reserve stabilization fund" would reduce the effects of cyclical troughs on the securities industry's capital position. Such reserves would, in effect, become extensions of a firm's capital base and serve as "insurance" against the effects of a cyclical downturn.

The need to provide increased stability in our financial markets was recognized during the 1940's, when the Internal Revenue Service allowed commercial banks to maintain loss reserves above actual losses. The favorable tax treatment extended to commercial banks and other financial intermediaries was based on the premise that a build-up of capital funds of intermediaries would increase the financial stability of the institutions and thus foster stability and growth in the financial markets. The effect of this favorable tax treatment has been to lower the effective tax rate in comparison to other financial intermediaries not receiving this treatment, such as broker-dealers, although Congress, in 1969, passed legislation phasing-out this preferential feature of loss reserves, but did so over an 18-year period.

While broker-dealers function as financial intermediaries to a lesser extent than banks, because most of their assets consist of funds contributed by

partners or shareholders, or accumulated out of retained earnings, rather than serving as an intermediary between many depositors and borrowers, the brokerage industry also utilizes customers' credit balances and acts in an intermediary capacity in three highly volatile and necessary functions to the U.S. capital markets — underwriting of corporate and noncorporate equity and debt securities, market-making and block positioning, and issuing margin loans. If a tax exempt loss reserve were established for these functions, the capital stability needed to perform these economic functions would be increased, reducing the risk associated with these functions for the entire industry and would increase the willingness of the industry to provide these vital functions at a reasonable cost.

Now, I recognize that repeated intrusions into the domains of other people, will surely bring me to no good. So I cannot make a habit of discussing tax policies in my speeches. But we have established a tax task force at the Commission which has reviewed relevant pending tax proposals. It is my hope that we can offer our views to Treasury and assist it in any way possible.

With the advent of unfixed rates, and our continued enforcement activities, many in the securities industry have complained bitterly that they have no government friends comparable to the bankers' friends. Given recent developments, some of you may wish to challenge the assumptions underlying that conclusion. But, we all have a vested stake in, and a role to play to assure the economic equilibrium of the securities industry. For our

part, we will not refrain from doling out bitter medicine, if it is appropriate to do so. But we can, and will, strive to be even more responsive to the needs of the industry we regulate and you support. From such efforts, will come a truly self-sufficient and effective capital market.