NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

HOLD FOR RELEASE: 1:00 P.M. EDT

# NEGOTIATED RATES: THE INITIAL EXPERIENCE

An Address By

Ray Garrett, Jr., Chairman

Securities and Exchange Commission

MAY 28, 1975

NEW YORK SOCIETY OF SECURITY ANALYSTS

15 William Street
New York City, New York

It was with some trepidation that I accepted the invitation to be here this noon. While it is a personal privilege to substitute for President Ford, in these hypersensitive days there is some question whether I am compromising the SEC's independence or violating some unwritten clause in the Constitution by being here for this purpose. I take comfort against this peril by noting that the amenities have been meticulously observed. The White House did not ask me to come. I was invited by your Society.

Of course, I also know that I was not your first choice of ceremonial surrogate. But it would be unseemly for me to take offense at that, inasmuch as being here today and giving these remarks was not my first choice of where to have lunch.

I do not mean to suggest that your society and its members are not the salt of the earth. Naturally you are, and the fact that you are generally in an ugly mood when I show up is surely no reflection on your overall sterling character and disposition toward buoyant hospitality. The other time I was here, you were still smarting over an unpleasant experience with your bill to register financial analysts. Fresh as I was from the annual meeting of the National Federation, I was imprudent enough to say some kind words about its voluntary program while referring to your society as the New York "chapter." On the whole, it was not a very happy scene. This time I have another topic equally well-suited to cementing our friendship -- negotiated rates.

It is not that I really want to say anything publicly about negotiated rates at this time and place. All of us at the Commission would prefer just to shut up for awhile and see how things work themselves out. But we seem to be expected to make public statements.

Sometimes it reminds me of the roving television crew that is lucky enough to be right on the spot when a mother watches her child get crushed by a huge truck. As the camera closes in, the reporter sticks the mike in her face and asks: "Tell me, Mrs. Loser, how does it feel to watch your child get crushed by a huge truck. All those viewers out in TV land want to know what is going through your mind at a time like this."

Sobbing, Mrs. Loser shrieks, "It's awful! Just awful!"

The reporter presses: "But tell us more Mrs. Loser. We know it's awful, but what does it really feel like?"

Gaining some composure and motioning to the camerman to get her from her good side, Mrs. Loser continues: "Well, it is quite a sensation, something I know I have never experienced before. In fact, no one on my block has ever had a thrill like this -- and with the TV camera right on the spot. You are shooting in color aren't you?"

Like Mrs. Loser, I can assure you that I am experiencing a new sensation for SEC chairmen. Things have been bad before, but who else has had the thrill of opening the cage and watching the lemmings race for the sea?

But is it really that bad? And what are we going to do about it? The answers are simple. It really is too soon to tell, and we are not going to do anything about it for some time, if ever. As to what is "some time," it depends upon when things seem to have shaken down to a long range pattern. When they have, there may appear to be something we can and should do, and there may not.

As to how bad the present developments are, we do not yet have any data that are accurate and comprehensive. You know about as much as we do by virtue of what your firms are experiencing and what you hear from others and read in the press and the services. Except for random inquiries and volunteered reports, our monitoring program is based upon monthly and quarterly reports, so it will still be the end of June before we receive the first systematic information. Meanwhile, is it an exaggeration to describe what is apparently happening as pointing to suicide in disastrous proportions? I think we would respond yes it is an exaggeration, although the long-term consequences cannot yet be clearly discussed because they depend upon some unanswered questions and what other developments come to pass.

The industry, the Commission and scholars have long struggled with cost allocation problems in the securities industry. The failure to achieve any consensus on the reasonable cost of brokerage service, taken alone, was one of the major considerations leading the Commission to May Day. If there is a reasonable method of regulating commission rates in the public interest, it had not, and has not, been revealed. We have all recognized that revenues from brokerage services supported many other services directly related, and some perhaps not so directly related, to the brokerage function. And the most prominent of these was research.

It now appears that the market is searching for the bottom on the cost of simple brokerage services to institutions. Whether it has found the magic point of marginal profitability for this service is one of the unanswered questions. It may well have overshot the mark, but we cannot yet be sure. We do not know what those firms that led the race expected by seeking to offer to work for half of the old fixed rate in order to increase their share of institutional business. Did they know or only hope that business would be profitable at that level? Or that it would be profitable only at permanently increased volume? If so, did they assume that they could have a prolonged monopoly on low prices and a permanent increase in market shares?

Obviously, if they acted on the last assumption, they were wrong, as they were certain to be. A so-called full service or research firm might be able to permit a modest unfavorable differential, but not 50 percent. One thing that might occur, of course, is that the game will endure until only the few best capitalized firms will be able to continue, with the rest driven out of business or forced to run for cover through mergers and the like. This could lead to a condition of oligopoly that would surely force some government response as well as some response from institutional customers who would be interested in performing the brokerage function themselves or avoiding it through increased direct trading. Extreme reduction in the number of brokerage firms is not a development that anyone should desire.

Can it be prevented without government action? And without non-governmental agreements, understandings or conspiracies? The answer is surely yes, it can, but that is not to say that the right things will happen at all or soon enough. This depends upon decisions to be made on both sides, by institutions as well as brokers. It depends in part on how much good sense is displayed in important quarters. But that is a frail reed on which to rely -- in this industry or any industry -- so it also depends upon experience and willingness to pay for value received and used.

If the securities industry consisted simply of brokers executing agency orders plus some market makers and block positioners, it is arguable that there would be no need for governmental concern. Through comptition, market forces would result in the right price -- as nearly as anyone could determine -- for such services of such quality as the market would support. How this turned out would be none of the government's business. If monopolistic tendencies developed, customary measures could be applied.

But the securities industry is not that simple. If it were, fixed commission rates would doubtless have been abandoned long ago. The complicating factor is all of the other services broker-dealer firms have supplied without compensation other than brokerage commissions. These are now surely threatened if the levels of compensation are in fact as low as we have heard. Viewing our economy as a whole, is this something the government should care about? In important measure, I think it should. And this is so despite our recognition of the fact that a lot of so-called services were being supplied either that were of no real value or to persons who did not want them.

The whole negotiated rates exercise -- passing the absence of an adequate rate-regulating theory -- has looked toward putting the broker-dealer industry on a more rational basis. That is to say, on a basis where customers should pay a fair price for what they get and want, where customers should not have to pay for what they do not want, and where broker-dealer firms could receive reasonable compensation for on-going services of value without being at the mercy of highly volatile volume-related revenues.

This is still the broad objective, and it looks as though it may work out in the retail end of the business. Firms that seek the business of many individuals are experimenting with different mixes of services at different prices and are reporting a favorable response from their customers. There is good reason to believe that the individual investor is going to be able to get more nearly what he wants from his broker at reasonable rates and that he will be better served.

There is much cynical talk that the individual is going to be taken because he is dumb and a patsy. I accept neither the premise nor the conclusion. It is true that many individuals would rather do business with a registered representative or firm that they know and feel comfortable with, even though basic services might cost less somewhere else. This is not necessarily dumb or uneconomic. Many of us do the same in our personal affairs, from purchasing life insurance to buying a lawn mower. On the other hand, the chronic bargain hunter should be able to find bargains, and this is good, too.

I do not mean to say by this that I think major retail firms can keep the retail rate at substantially the old fixed rate while institutional rates stabilize, if they do, at 50 percent off. The individual may not move his occasional business for marginal savings in transaction costs -- he may, among other things, accept the idea that his business is somewhat more expensive for the firm than a like trade from an institution -- but too wide a differential may be unacceptable and not sustainable.

From an over-all industry point of view, however, an apparent problem is where many industry spokesmen said it would be -- with institutional research. But how big is the problem and how serious is it? Size makes a difference. It is one thing to talk about paying up when the differential is a few percentage points. It is another to talk about paying twice as much.

But a signal fact so far is that many fiduciaries have apparently not yet had to think about paying up or finding a basis for hard dollar compensation, because they are getting it all for the deep discount price. There is no so-called fiduciary problem if the execution-plus-research firm is matching penny for penny the execution-only firm. If this becomes the settled pattern, the execution-plus-research firm -- other things equal, which they often are not -- will take the business from the execution-only firm, which is what they hope to do, unless they sooner go broke supporting all the research capability, in which case the execution-only firms inherit the world and street research for institutions disappears.

Would that be a bad thing? It would obviously be bad for a good many of you people, but would it be bad for the economy? As I said before, we all know that some street research thrust upon institutions is not worth much, and its disappearance would not damage our capital markets perceptibly. Negotiated rates should, among other things, expose street research to the heartless test of value and cause the elimination of that portion without sufficient value to induce anyone actually to pay for it.

But much of what we call street research is valuable. It is valuable just for being there, to the extent that it produces diversity in investment views. The capital markets suffer quite enough already from the manic-depressive emotional state of Wall Street and the fondness for fads in investing. The situation would not be improved by a further concentration of investment ideas and attitudes. There are many problems still to be solved in the search for higher average professional standards in securities analysis.

We still do not know how to equalize the rewards of giving sell as against buy advice -- to say nothing of hold advice. Several years ago in a panel discussion that got off on unbundling, I put what I thought was the absurd case of the customer who calls his broker and asks if he should buy or sell. The broker says "Hold -- and that will cost you $25". This seemed amusingly unrealistic at the time, and may still be at the individual investor level, but street research will never merit this exalted designation nor will its practitioners be truly professional until it and they are more or less equally rewarded, whichever in their informed judgment is the wiser recommendation. But, whether or not street research is professional, it would surely not be improved by its disappearance.

The trouble here is not really that institutional investors regard street research as without value. There is a great deal of useful information that institutional salesmen and traders can purvey, much of which is current market information that even the euphemistic penchant of the securities industry would not exalt by dubbing it "research," but it may have value not available in-house. There are two problems. One is that under these immediate circumstances one can hardly expect fiduciaries to pay extra for what they can get for nothing. The worse, long-range, problem is justifying fiduciaries paying for research, assuming that brokers' practices evolve so that it can no longer be had for nothing. This is a critical problem for smaller institutions that cannot afford extensive in-house research capability. Some legal means must be found for them to obtain the information they need on a reasonable basis lest we force even further concentration of portfolio management. But even the largest institutional staff cannot know everything all the time.

There is no time for me to attempt a lecture of the legal duties of fiduciaries managing portfolios. This field has been well plowed, not to say fertilized, for many months, and I have no fresh insights into the legal hazards. Regardless of how clearly one sees the law as it ought to be, law suits to the contrary are always possible and always messy and expensive even when you win. Nothing I can say will change that sad fact.

Nevertheless, there are things to say to institutions as well as to brokers. As long as broker-dealers are throwing everything at the institutions at deep discounts, I suppose we cannot expect the institutions to resist. When you can get everything you want for 50 cents, why should you pay a dollar? But suppose the securities industry -- especially the full-service firms, those with research -- cannot long survive, or at least prosper, at such deep discounts. Will the institutions support the firms offering research in an effort to raise rates, or will they continue to favor the execution-only discounters, thereby saving a buck today, but contributing to the withering away of something that collectively they very much need?

If the full-service firms, and firms strong on research, find that they can survive and prosper at present rates, then, of course, there is no public problem. It would seem to make a mockery of our recent hearings on fixed rate levels, but so be it. If not, then some willingness to support street research must be shown and some legally acceptable means of paying for it must be devised or our capital markets will suffer an unintended loss of diversity and resiliency through negotiated rates. I fully expect institutions will come to realize this if and when the prospect of the demise of street research on a large scale becomes imminent. If the institutions are wise, they will come to this realization before the services they need have actually begun to disappear. At some point, and the sooner the better, institutional trading strategy must be governed by those persons with over-all responsibility for portfolio management and not left to the traders, as now seems to be prevalent, with the sole mission of lowest obtainable commission rates. Let me mention a particular example of what we are told is occurring in many quarters. It would seem to me that, logically, an institutional trader who determines that he is obligated to obtain low cost brokerage charges on a particular order cannot afford to lose sight of the forest for the trees. Cheapest is not best if he misses the opportunity to trade at a more favorable price by haggling before ordering the broker to execute, over a few cents per share.

But the institutions cannot do it by themselves. As long as the full-service and research broker-dealers insist upon meeting the competition of the execution-only firms, dollar for dollar and penny for penny, the institutions would seem to have no choice.

Before concluding, let me say a word about what the Commission might do, if it is to do anything. The new securities legislation is just about to become law, and we must think of our possible moves as circumscribed by that law. It leaves us relatively free to adopt rules curtailing various commission rate practices that might appear contrary to the public interest. I am speaking of rebates, discriminatory pricing, and like matters. Or the several exchanges or the NASD might adopt such measures. One can even imagine a rule which would forbid the gratuitous furnishing of investment advice, requiring that it be separately paid for. Neither we nor any of the self-regulatory bodies is anxious to get into this business, but some or all of us might have to.

The real question is whether we could or would reestablish fixed commission rates, or permit the New York Stock Exchange to do so. Whether we would, I refuse to speculate on at this time. Whether we could, is more discussable.

The new law authorizes us, until November 1, 1976, to establish fixed rates, or permit them to be reestablished, on a finding, after a hearing, that it would be in the public interest and the interest of investors to do so. Under this provision, we cannot refix rates tomorrow or next week, even if we were so inclined. But we could do so in due course after the procedural requirements were satisfied.

Beyond November 1, 1976, however, it is another story. From that time on, we can compel or permit fixed minimun rates only after finding, after a formal hearing, that that would be the measure with the least anti-competitive effect needed to avoid absolute disaster. The actual statutory language permits us to reimpose fixed rates after that date only if we find that such fixed rates "(i) are reasonable in relation to the costs of providing the services for which such fees are charged (and the Commission publishes the standards employed in adjudging reasonableness) and (ii) do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title, taking into consideration the competitive effects of permitting such...fixed rates weighed against the competitive effects of other lawful actions which the Commission is authorized to take. . . ." Many observers wonder whether we could ever make such findings and sustain them in court.

It is always possible, of course, to go back to Congress for relief, but such relief may not come quickly or easily. The practical situation is that the securities industry and the institutional investors must make negotiated rates work. It is not yet evident how they will succeed, but they will.

I do not want to minimize the difficulties, or appear indifferent to the pain, which direct participants in the securities industry may now be enduring. The industry has had little experience at this sort of thing on which to draw, and analogies to other industries are helpful but inconclusive. And we know, as do you, that not every firm or every job is going to survive or survive as well. It will help immensely, however, not to be too quick to push the panic button, and not to believe everything you hear. The famous rumor mills of Wall Street can induce fears and impulsive responses that can only result in unnecessary damage. Most of the things that you hear and fear have not occurred and will not occur, if some calmness and patience are preserved.

We have been urged by a very few persons to restore fixed rates immediately. This seems clearly inadvisable. Some others, with a better feel for reality, have urged that we quickly convene a hearing to develop a public record of what is actually occurring, with a view possibly toward some administrative action but primarily to restore some calm and stem the mad rush. We have given this idea careful consideration and decided against it at this time. We do not want to contribute to fear by displaying dramatic consternation ourselves. Furthermore, we simply must let things work out until everyone can see a clearer picture. Accordingly, we at the Commission will continue to watch, with some apprehension, but also with confidence and optimism.