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Detroit Stock
cross- to give
give ups.

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Attached hereto are excerpts from testimony by a third market broker who joined the Detroit Stock Exchange at the instance of certain mutual funds to "legalize" the over-the-counter give-up.

FROM: David Silver | DATE 4/30/65

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Testimony

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Excerpts from Charles P. Stetson's Testimony

A: My name is Charles P. Stetson and I am president of the Stetson Securities Corporation, 1239 Post Road, Fairfield, Connecticut.

Q: Is your firm, Mr. Stetson, a member firm of any exchange?

A: Yes. We are members of the Detroit . . . .

Q: Can you tell us very briefly your own personal background in the securities business?

A: I went in the business on June 1, 1944 with J. & W. Seligman & Company, New York. I was with them until 1951 and then I formed Stetson & Company. . . .

* * * *

Q: Can you tell us something about your organization now? How many employees you have?

A: Yes. I have two really, besides myself, one part time man or one really consultant, which would be four including myself, including the part time and consultant, who helps us with our back office and accounting work.

* * * *

A: . . . Our present business is just a hundred per cent [brokerage] institutional business really -- we don't deal with the public -- which institutions include mutual funds, insurance companies, banks, and we really got into the institutional business, say in 1958 in a big way and it was just specialized. We used to do underwriting and we cut out everything else and just specialized [in crossing blocks].

We didn't join the Detroit Stock Exchange until a couple of years ago and, of course, I am sure you know the reasons why we did. It was to do a reciprocal business with mutual funds. We are not by any means a large factor on the Detroit Stock Exchange.

We have competition that does quite a bit more than we do.

We joined the Pacific Coast Exchange and the Boston Exchange also for the same reason, but we found that it was not economical to stay a member of the Pacific Coast Stock Exchange. It was at one time. . . .

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A: . . . I think the growth of institutional funds is really what stimulated us [to give up underwriting and dealing with the public], the fact that we felt it was a kind of a vacuum in this type of [block] business, which there was I think at that time.

Now, there is tremendous competition. An awful lot of people have come in since that time. I'd say I first began to notice it about 1949 or '50, I began to notice institutions became a factor when they changed the New York State law. I think it was changed about that time to permit pension funds to invest up to 35% of their [funds in] stocks.

So our basic business in '58 was just simply saving people money, taking advantage, of course, that the New York Stock Exchange had no volume discounts.

Although I will say this: I think that in our minds when we started out we thought that the [lack of a] volume discount was a major factor in our success. I think it is not really a major factor -- it's a factor, but I think the institution is really more anxious in getting the block regardless of whether they get it at the New York Stock Exchange or over-the-counter. If they want to buy something I think the availability of the block is first and I think the commission is secondary. I think they would rather do business with us than a member of the New York Stock Exchange.

Q: How does your business operate? Do you use circulars?

A: Yes. I didn't bring one with me, but we do send out a circular once a week, indications of interest where we have buying interests and selling interests.

We say that we have had a buying interest in a thousand shares or more of such and such a stock.

We send it to a very limited group of people for several reasons; one is we don't want to influence the market, we want to be very careful who gets it. . . .

* * * *

A: . . . They [the institutions] indicate what they want to do. It's not a firm order. It's an indication of what they want to do and it's subject to price.

If we come back and we are able to offer them something on the buy side, they don't necessarily take it. The price might have changed or somebody else might have filled them. They might have bought the stock on the New York Stock Exchange if we were too slow. . . .

Q: To break down your customers, about what percentage of your customers are mutual funds, what percentage are pension trusts.

A: I say that mutual funds are by far the largest.

They are the backbone of the business.

Q: They account for more than half of your business?

A: Oh, yes.

Q: Generally, how does your pricing work? Do you subscribe to the New York Stock Exchange ticker?

A: We get the Ultronic Machine, which gives us the last sale. It doesn't give us the bid and ask.

Q: Let's say you have gotten an indication from the potential seller and now you have gotten an indication from a potential buyer for the same amount, what will happen next?

A: We will try to execute the order assuming that -- most of the people we deal with, the basic assumption is that they will do the trade at or close to the last sale on the New York Stock Exchange, depending upon the bid and ask. And after a while you get used to calling, you call and talk to these people every day and you pretty much know whether they will do it at the last sale and you can almost make that assumption, unless the seller is very anxious.

By and large, we assume, unless they tell us differently, that it would be done at the last sale.

* * * *

Q: If you get an indication from the buyer that he is interested in the last sale at the bid or offer price, then you take that back to the seller?

A: Yes, then you negotiate.

I have negotiations that lasted a week. These were large trades where they wait for the market and so forth.

Several times also you show an institution that you are a seller or something and they will see it on your list and they may take it into their research and their research may try to decide whether they want to by it or not.

We had institutions that say, "Do you see any stock around. We may want to take a position of one or $2,000,000. We just don't want it to start with." They may not take a position in it because it's an inactive stock.

I would say in that regard most of our trades would not be in stock where it is General Motors and United States Steel. But there are a lot of stocks that may only trade, say a thousand shares a day on the New York Stock Exchange and that's really a better type of stock for us to operate in because I'd say basically the buyer and seller want the execution, that leads me to believe that the Commission is really a secondary consideration, although it's important.

* * * *

Q: Aside from any give-up or reciprocity, what is your usual commission?

A: I wish I could say there was a usual one.

We like to charge a quarter of a point, and if we can get a quarter of a point, and if we can get a quarter of a point on both sides, usually in the price range of investment grade stocks, very often that amounts to about half the stock exchange commission, so we assume the people are fairly satisfied with that kind of arrangement.

We don't always get that much.

The Commission is undoubtedly and unquestionably negotiated. . . .

Sometimes we do it away from the last sale and it is a large trade -- well, we don't do it for a quarter of a point. We will get down to an eighth of a point. And in certain instances if our trades are really large we may do it net on one side and just an eighth on the other side; but both sides know about this, what we are making on the other side and they do it at the time of the trade.

We will not do a trade for less than an eighth, across for less than an eighth.

Q: An eighth for each side?

A: No, an eighth on one side, but the man on the other side is getting it net.

He also knows about this and he adjusts it in the price. Basically, I thought that both sides should pay the commission whether it's in the price or the actual quarter or eighth or whatever the situation is. We try to have both sides pay equally on the thing.

We feel we are rendering both sides the same service.

Q: You say in the ideal case, though, you would get a quarter from each side?

A: All things being equal, we will ask that much.

Q: So you would end up essentially on the whole transaction with about one stock exchange commission?

A: Yes, it's about that, but that's unusual.

We get a quarter of a point on both sides. We always ask what we think is the maximum and then we settle for less.

Q: But even your maximum would be about half as much where they went to the Board?

A: Yes, approximately. . . .

* * * *

Q: Mr. Stetson, up to this point you have been discussing how your business operates, basically through your telephone and the circulars.

Now, can you explain to us how the Detroit Stock Exchange comes into the picture?

A: Yes. Basically our business was designed to just save people money, and the mutual fund business competition is, I guess, so great in that business to get reciprocity out to the people that are selling their funds that many of the funds asked us to join the Detroit Stock Exchange, and we resisted the thing for a couple of years.

One of our competitors, Leonard Frisbie & Company, I think they were the first to join the Detroit Stock Exchange, and finally competition was coming in to our business and we simply had to join the Detroit Stock Exchange to keep doing block business with the funds. But we kind of walk a tight rope because most of the people we still deal with don't care about reciprocity. The banks don't care about it, the pension funds don't care about it and we still wanted to do business with them.

They obviously couldn't care less about the Detroit Stock Exchange, but by the same token we -- then we realized the availability of the block is really ultimately the most important thing, so we persuaded some of the people that couldn't care less about reciprocity to -- they had simply had to give us the full commission on the stock exchange trade. They had no money to give up, unless research in institutions have that kind of an obligation, but I guess they feel they take care of that some other way. But [these] institutions basically want to save money. . . .

* * * *

THE WITNESS: . . . There are certain funds that don't care about reciprocity and they are the ones that have their own sales force, like Hamilton and United Funds, to a large extent, out in Kansas City.

Q: Let me ask you one other question about Detroit.

As you understand the rules of the Detroit Stock Exchange, suppose you have a block of stock which is traded on that Exchange, a dually listed stock and neither party to the transaction, as you finally arrange it, is a fund and as you put it, they can't care less about Detroit or anything else, do you just go ahead and cross that in the over-the-counter market?

A: No. If it's listed on the Detroit we have to go to Detroit. . . .

Q: Did you ever ask for permission from Detroit to cross a block off the board?

A: Well, Detroit has a rule, so I understand it, that when -- if we had a fund on one side and they wanted to do it in Detroit, we have got to do the business in Detroit.

But when we can't find the other side, [except for] some dealer . . . we can get permission to [trade net with a dealer]. They would give us permission to do that. It seems logical that they have a rule like this.

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not?

A: Detroit is really a market, so unless you have a cross you really don't have a trade, You know, it's about twice the size of this room.

Q: In other words, you don't go to Detroit to find the transaction?

A: Absolutely not.

Q: You bring the transaction to the Detroit?

A: Yes. They may do odd lots. I don't think they head of this [block] business before. This is all brand new to Detroit. The 40% give-up [to non-Exchange members] I don't think they anticipated [the mutual fund aspect of the give-up]. I think this was to bring [small non-member]business to Detroit. They never knew what a bonanza this was going to be.

Q: How much did your member seat cost on the Detroit Stock Exchange?

A: $3,000, and I heard they sold one for fifteen. It's the most expensive [regional exchange] seat. Except that we just sold our seat on Pacific for fifteen. I think the reason there is because United Funds has an application to join and, as you know, the reason they are joining is to pass along their savings to the stockholders -- rather, it's a subsidiary of their management company.

Kansas City Securities is joining with the idea that they will pass on savings to their stockholders of United Funds.

* * * *

Q: When you have a bank or an insurance company on the other side, do they ever give you instructions to give up?

A: Very seldom. I think IDS has given us instructions -- well, IDS is really in the category of a bank because they have a [captive] sales force, but they have asked us to give up somebody who gave them service.

Q: That could be a member of Detroit which could also be a member of New York?

A: Yes, I think so.

Q: How about United Funds?

A: You see, they not only have their own sales force, but I think about ten, fifteen per cent of their business comes from -- through dealers and so -- their primary objective is to save money, but if you do something on Detroit they can't save money they may as well get the mileage out of the situation, so they ask us to give up that 40% to somebody who sold their funds.

Q: Had they ever asked you to give up to their management company?

A: No, they haven't.

Q: Has any mutual fund asked you to give up to their management company?

A: No. I don't presume they could unless they are members of the NASD.

Q: Well, many of them are.

A: Yes, that's true.

Q: You could if they asked you, couldn't you?

A: Yes. We could give up to any bonafide NASD member. I suppose they feel that [it] wouldn't go back to their stockholders . . . and maybe it's an advantage to the fund to increase sales.

Q: Of course I take it, as far as you know, the Detroit Stock Exchange doesn't care what happens to the money as soon as it's given up to an NASD member.

A: That's right.

Q: Their jurisdiction ends there, so to speak?

A: Right.

Q: Who do you generally use on the Detroit Stock Exchange to execute your orders?

A: We use Roney & Company.

Q: Just to pin this down, you have both sides of a transaction and then you call Roney by phone?

A: Yes [we] ask them to cross the trade there.

Q: Doesn't that create some uncertainty as to the pricing?

A: When we do a transaction, we say, this is subject to crossing it on Detroit. We have never run into any problem in crossing any on the Detroit because Detroit seems to be perfectly happy to do it in the last trade of the New York Stock Exchange, and Detroit is not much of a market. . . .

Q: Theoretically, some other Detroit member could upset your cross, has that ever happened?

A: No, that has never happened. I presume the reason there again is that nobody leaves an order of any size there on Detroit.

Q: What about your non-fund customers, are they somewhat mystified or unhappy at the fact that they are paying a full commission on the Detroit Stock Exchange?

A: Well, they don't like it and as a result we are treading both sides of the fence and we have lost something there. We actually prefer it not to be members of Detroit, so I think we have lost somewhat with our customers. But then ultimately the most important thing, as I say, is for the purchaser to get the block of stock.

That is the primary objective of most buyers or sellers: is to get the execution and they can certainly justify the thing because 95% of the business is done in New York anyway, so they are paying no more and anything they can save, of course, is a plus.

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Q: On stocks which are not listed on the Detroit Stock Exchange or not admitted to trading on the Detroit Stock Exchange, do the funds ever give you any give-up instructions in those transactions?

A: They used to. This is not a common practice and I don't think -- this is when the whole business sort of started out and people were feeling their way along as to what they could do before Detroit really became a factor.

Actually, our competition -- we weren't the first people in this business. Our competition was doing it, so the funds would say, your competition is doing it, will you do it for us and, of course, we said fine. It's practically disappeared, I'd say, and I think it's non-existent for all practical purposes at the present time.

* * * *

Q: I take it from everything you have said thus far you would be just as happy or even -- from the viewpoint of your own customers -- even happier to be able to do business as you originally started, and that is to cross these transactions in your office and negotiate compensation.

A: Yes.

Of course, we cross them really in the office and then the Detroit is just a formality -- I mean going out there. Well, our primary business is just to do this block business and we really don't keep -- we have to go with the wind, you might say, and if you want to do it on Detroit -- I think competitive reasons has driven these funds to do it there, so they no choice in the matter really. The thing is -- your study shows the whole reason behind the thing -- it's the New York Stock Exchange. This gets off on another subject really, but I just feel it's a shame in a way and this would probably hurt our [own] business that here you have the New York Stock Exchange which is really the apex of our great system and they are really, I think, dragging their feet, [in] modernizing -- of course, I think the institutional business is new, I think the New York Stock Exchange pushes the institutions around and United Funds is one of the few that is fighting back. They are getting to the size where they can fight back, particularly somebody like United Funds, and it's just really basically ridiculous, as you point out in your Study, that there is no volume discount.

Q: Do you remember any particular event which made it appear to the funds that it would be better if these transactions were arranged on Detroit rather than in the over-the-counter market, the give-up transaction?

A: We weren't the first to go on Detroit. I think Frisbie was the first to go on and he drew it to their attention.

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Q: Do you recall any particular funds coming to you and urging you to go on the Detroit?

A: Well, the urging is strictly indirect. The funds would say, well, we are doing business with your competitor.

They didn't tell us to join, but they would say we are doing business with your competitor, so we really have no choice in the matter.

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Q: Can you give us some idea, Mr. Stetson of what your gross commissions were in 1964?

A: Yes.

About $400,000.

Q: Now, that was before give-ups?

A: No, this would be after give-ups.

Q: So it would be, I guess, around $600,000?

A: Yes.

* * * *

Q: Your contact with Detroit then is basically limited to Roney & Company [the floor broker]?

A: Yes.

Q: And you have nothing else to do with Detroit, I take it?

A: No. I never go out there. I have been out there once. I just call on the phone and ask for the cross.

Q: Does he give you an immediate report by phone?

A: Yes. We stay around the phone until he tells us that it can be done.

Q: How often can't it be done?

A: Never

Q: That is consistent with what you said before.

A: Yes.

* * * *

Q: How is [a Detroit] transaction actually cleared?

A: We clear -- we are members of a clearing house out there, but we never really had occasion to use it except in the beginning a little bit. We clear all our business through the First National Bank of Jersey City.

Q: I see.

A: And which is a fantastically good bank and very aggressive. The reason we use that, they are five minutes away from Wall Street and in certain instances where the transfer agent is also outside of the State of New York and the seller is outside the State of New York, we don't have to pay New York State tax.

Q: So Detroit is really nothing but this telephone between yourself and Roney?

A: That's right.

Q: Certificates aren't sent out there or transactions aren't cleared.

A: That's right.