September 22, 1967

Mr. Robert W. Haack
President
New York Stock Exchange
Eleven Wall Street
New York, New York 10005

Dear Mr. Haack:

We have examined Mr. Funston's report, "Across the President's Desk" dated July 21, 1967, in which he stated that the Exchange's Special Committee on Member Firm Costs and Revenues is exploring a change in the commission rate structure based on the dollar size of the order rather than the price of the stock. We welcome this current effort toward rationalizing the commission rate structure in terms of today's trading needs, and urge that a resolution be reached in this concededly complex matter with all due speed. To this end we are prepared to coordinate our consideration with yours to the extent possible and consistent with our responsibilities under the Exchange Act.

We believe that it may be useful to the Special Committee for us to make some preliminary observations on certain aspect of the report.

There seems to be more than an implication in the report that any change in the commission rate structure should produce an increase in commissions paid on small transactions. The report states that firms handling both large and small transactions adjust for loses on small transactions by using income from their large trades, but that firms which primarily handle small trades cannot offset their loses this way. The report concludes that commissions on small trades should, therefore, be brought "more nearly into line with small trade costs." However, if commissions on small trades were profitable for certain members (either because of their product mix or efficiency) a serious question should arise whether a commission rate increase could be justified because of the unprofitability of small trades for other firms. As you know, the several firms doing the largest portion of securities commission business are quite profitable, particularly if all income fairly related to the securities commission business is taken into account. The consequence of any increase in commission rates would, of course, result in increases for all investors, including the very substantial number who deal with the larger firms.

The report mentions the problem of "the effect of overall commission rates of the long-standing trend of a rising average price of shares traded" which results in lower proportional commissions on higher priced stocks. It points out that, as measured on October 16, 1963, commissions as a value traded was .98% while on October 19, 1966, it was .89%. We note for the Committee's consideration, however, that between 1963 and 1966, while the average price of a share traded

rose 10% (accounted for the lower “proportional” commissions), total shares rose 63%, share volume per registered representative rose 31%, and shares volume pre office rose 43%. However, the average prices per share traded from 1960 to 1966 were as follows:

1960 -- $39.60

1961 -- $40.80

1962 -- $39.90

1963 -- $40.60

1964 -- $40.80

1965 -- $40.50

1966 -- $40.70

It is clear that the experience of 1966 necessarily reflects a long term trend. Further, since the average price of shares traded by institutions is higher than the average for individuals, an increase in the Exchanges aggregate price per share traded may represent institutional activity in large transactions which, as the Exchange recognizes, results in the most profitable type of commission income. We note that, according to Exchange figures on the average daily volume break even point, the percentage by which actual average daily volume exceeded break even volume increased from 18% in 1963 to 28% in 1966.

The Income and Expense Report states that aggregate net profit declined from 5.8% in 1965 to 5.7% of gross revenues in 1966 for security commission business, The Exchange notes that this decline took place despite a [illegible]% increase in share volume for the same period. It should be added, however, that profit after taxes for members (even on the bases used by the Exchange) rose from about $52,000,000 in 1965 to about $100,000,000 in 1966, which coincidently represents a 22% increase in profits. The absolute and percentage increase is even greater when the savings from the use of free credit balances are considered.

The Commission would appreciate as soon as possible before any proposal for modifications of the structure or level of commissions is submitted to it, a careful exposition of all relevant factors including the following which seem to us at this stage particularly pertinent:

1. The extent to which some firms are less profitable by reasons of their relative inefficiency. We are confident you would agree that a commission rate structure

should not be designed to make all firms profitable whether or not some are significantly less efficient than other firms.

2. All the income received by member firms fairly attributable to commission business; for instance, the income derived, or expense obviated, by reason of the use of free credit balances and from margin transactions. We not that revenues in 1966 from margin transactions, according to the I&R Report, exceeded those earned in 1965 by 27.41%.

3. The proper allocation of partner's compensation. Alternative methods of making allowances for partner's salaries, as distinguished from the method reflected in the I&R Reports, would result in substantial change in the reported profitability of commission business to many firms.

4. The propriety of expensing, rather than capitalizing, start up costs in connection with the opening of new branch offices and the automating of certain back office operations.

5. Charges by these firms which set as correspondents or otherwise execute or clear transactions for out of town firms. We note from the Exchange's 1966 I&R Report that Commissions paid to others by non clearing firms -- essentially their correspondent's charges -- represented the greatest item of expense (with the exception of partner's compensation) for every size category of non clearing member firms. This expense was even greater than registered representatives' compensation for such firms. We believe that the practices and charges in this area are relevant to the issues involved in any modification of the commission structure or level. Consequently, we also believe that the Committee should address itself to the fairness of, and the feasibility of a change in, the rates, the rates charged to out of town or non clearing firms in light of the contributions of each group to the operation and liquidity of the auction market.

6. Current practices of attributing certain expenses to commission income which might be allocated elsewhere. One example is give ups directed for mutual funds sales. The I&R Report for 1966 reflects the fact that this expense, in the case of clearing firms, increased from 1.6% of security commission income in 1966. While this expense is charged against commission income by other firms -- who may or may not be Exchange members -- the charge or receipt appears unrelated to the brokerage function for which the commissions are paid. On the other hand, it does appear related, in a great many cases, to income derived from mutual fund sales which is not included in the I&R as commission income.

Our analysis show that large clearing firms give up substantial portions of their commission income derived from transactions on behalf of certain institutional investors to smaller non clearing firms. Give ups frequently are directed by mutual fund managers, primarily to firms which sell the shares of the mutual fund sponsors by those managers. The large firms often retain substantial portions of

the commissions received in a connection with portfolio transactions as lead brokers, as a supplemental reward for calling mutual funds, for other services or for a combination of all or some of them. If the Exchange adopts a workable volume discount, this may reduce the income available for give ups. For the lead broker, however, a reduction in commissions on its large orders, will, for the most part, only reduce the amount of the commission which the lead broker already finds that it can afford to give away economically. Its position, therefore, would be relatively the same. The income of the give up recipient would, however, be reduced. The question remains whether an increase is justified for all firms to compensate for the reduction of income of some -- particularly where the bulk of increased income would go to the large firms. While it appears feasible to lower commission costs on large trades (as evidenced by the fact that member firms apparently are able and willing to give up substantial portions of their commissions on such trades), it remains to be proven that increases in the rates on small trades are necessary to a fair commission rate schedule.

We, of course, assume that any proposals to change the structure and level the commission rates, and particularly any proposal to increase commissions for small investors, will be based on a thorough analysis of all relevant factors, not limited to those noted above, and will take cognizance of current volume trends.

Again, we wish to urge upon you the need for expedition in resolving the difficult problems which exist and are growing, and the new ones which seem to develop, under the existing commission structure. That structure was established some years ago to deal with a market which has since undergone, and is still undergoing, fundamental changes. We are prepared to discuss these matters with you at the earliest possible time.

Sincerely,
Manuel P. Cohen
Chairman