OFFICIAL TRANSCRIPT OF PROCEEDINGS

BEFORE THE

Securities and Exchange Commission

FILE NO. 4-144

In the Matter of ....

S.E.C. RATE STRUCTURE INVESTIGATION

OF NATIONAL SECURITIES EXCHANGES

Place Washington, D.C.

Date December 10, 1968

Pages 4185 thru 4258

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SECURITIES AND EXCHANGE COMMISSION

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Room 776 S.E.C. Building
500 North Capitol Street, N.W.
Washington, D.C.

Tuesday, December 10, 1968

The hearing in the above-entitled matter was reconvened at 10:00 o'clock, a.m.,

BEFORE:

ROGER S. FOSTER, ESQ., Presiding Officer

APPEARANCES:

(As heretofore noted.)

E X H I B I T S

P R O C E E D I N G S

MR. ROTBERG: The witness today is Mr. Bernard H. Garil.

Mr. Garil, would you stand and be sworn?

Whereupon,

BERNARD H. GARIL

was called as a witness and being first duly sworn by the Hearing Officer, was examined and testified as follows:

THE WITNESS: My name is Bernard H. Garil. I am a financial economist on the staff of the Securities and Exchange Commission where I serve as Chief of the Branch of Market Analysis in the Office of Policy Research. The Branch is responsible for the analysis of economic and financial data of the securities industry. Our findings are reported to the Commission and officers of the Commission for the purpose of keeping the Commission and the staff informed of industry matters and to aid in the determination of Commission policy.

I personally have been studying economic data of the Securities industry since 1962 when I participated in the Special Study of the Securities Markets. Since then I have served in varying capacities in the Office of Policy Research, including a period where I served on the task force which assisted the Commission in its preparation of the report, "Public Policy Implications of Investment Company Growth."

The testimony which I am about to give is my own and should not be construed as expressing opinions of the Commission or of any other member of the Commission's staff.

At this time, however, I would like to thank those members of the staff who aided me in the preparation of today's testimony and those who gave me those helpful comments.

The purpose of my testimony today is to present certain data and analyses which are relevant to the major questions under discussion. I hope that my presentation will aid in eliciting informed comments from interested persons.

Although these proceedings have been going on for close to half a year, testimony to date sheds little light on one of the major questions under consideration in these hearings: That is, assuming for the moment the desirability of fixed rates of commission, at what level are these rates to be fixed? Many prior witnesses have discussed the structure of the rate schedule. For instance, the record is quite clear that there is almost complete unanimity that the rate for executing a trade of ten thousand shares should be something less than 100 times the rate for executing one round lot. Little has been said, however, about the method for determining what should be the charge for executing a single round lot. If rates are to be fixed for executing 100 shares of a $50 stock, is $44 the proper level? Should it be $25, $43.50, or $80? At what level should rates be set so that brokerage firms recover the costs to them of doing business plus a fair profit?

If the level of commission rates is to be fixed by any manner other than the forces of competition, certain questions must be answered. First, with reference to the impact upon what specific firms should the reasonableness of rate levels be determined? Second, which segments of the business of any firm, such as security commission income, margin interest, trading, underwriting, etc., are to be taken into account in determining rate levels and third, what rate base and what return on that base or other measure of reasonableness is appropriate for the securities brokerage business.

The question of which firms one must consider in fixing commission rates is a very complex one. The New York Stock Exchange has looked at data for all of the members filing the Income and Expense Reports and primarily, on the basis of those firms, has attempted to make rate determinations. The Securities and Exchange Commission, however, need not so limit its scrutiny for slight changes in commission rate levels by the New York Stock Exchange --

HEARING OFFICER FOSTER: Excuse me. At this point, is it your comment that the New York Stock Exchange has looked only to the limited number of firms which file Income and Expense Reports, and the Commission might have to consider other firms?

THE WITNESS: Right. To the best of my knowledge, the New York Stock Exchange collects data on economic expenses from only these firms. There is no data available for other firms in the industry and as I will point out in a few moments we hope to get some more data to help us in this problem.

These changes can have tremendous repercussions on the regional exchanges, the third market, the over-the-counter market, and the trading patterns of investors.

The setting of commission rate levels has fallen historically to the New York Stock Exchange, and most other exchanges have chosen to follow that Exchange's lead. In order to help make these determinations, the New York Stock Exchange, since 1961, has obtained from those of its members who do business with persons other than the New York Stock Exchange members a detailed Income and Expense Report. Although the Exchange has more than 650 member organizations, only about 375 to 400 of them carry public accounts. An additional 160 or so firms receive orders from members of the public but these accounts are introduced on a fully disclosed basis to other member firms who confirm the execution to the customer. These latter firms do not presently file Income and Expense Reports.

EXAMINATION BY MR. ROTBERG:

Q Mr. Garil, when you say, "These latter firms do not presently file Income and Expense Reports", do you mean that the firms who receive orders from the public but transmit them to other firms who carry the account on a fully disclosed basis, that it is the firm who receives the order from the public that does not file the Income and Expense Report?

A That is correct.

Q But the firm who receives the order, that is, who carries the introduced account, that firm does file the Income and Expense Report?

A That is correct.

Q So that when you refer to these latter firms, you do not mean the carrying firm. You mean the firm who transmits the order.

A That is right. It is the firms that transmit the order; they are the ones who do not currently file an I&E Report although I think it should be pointed out that situation will be shortly rectified.

Unfortunately, at this time, we have no data for firms other than those filing the New York Stock Exchange Income and Expense Reports. By 1970 this condition will be rectified in part by the required filing with the Commission of financial reports of various degrees of detail by all registered broker-dealers. Unfortunately, these reports, like the current New York Stock Exchange reports, will suffer from inconsistencies stemming from the use of varied accounting techniques.

HEARING OFFICER FOSTER: At this point, I think it would be helpful to find out, to state for the record, the status of these New York Stock Exchange required Income and Expense Reports, with reference to their availability to the public.

THE WITNESS: Right. The reports are now filed, are not available to the public. They are collected by the New York Stock Exchange and other than the Commission, who I believe has subpoenaed the reports on a continuing basis, the reports are not available to people in the public except where the Exchange has published some limited aggregate data; and the

Exchange also prepares a booklet every year which shows certain ratios. This booklet however, is addressed to managing partners, and is not generally available to the public.

HEARING OFFICER FOSTER: I am not sure whether this is an appropriate question for you but I think that it might be appropriate to point out that the problem appears to be that while the New York Stock Exchange collectively has what might be called a monopolistic position and therefore is subject to rate regulations, since the member firms are highly competitive with each other, there is a resistance to making the same kind of public disclosures that would be normally made by a public utility or other regulated monopoly, because of the possible impact upon competition among member firms.

THE WITNESS: That would be one possibility but there has been a trend lately for some of the larger firms and even some of the smaller ones, to publish material such as this on their own.

HEARING OFFICER FOSTER: Well, are the required filings with the Commission to become effective in 1970 to be public?

THE WITNESS: No, they are not.

HEARING OFFICER FOSTER: They will be on a confidential basis?

THE WITNESS: Right. It is intended that aggregate data will be published but the data will not be available to the general public. Unlike the present situation, however, since all broker dealers are going to be filing this data, the data will be available to parties such as the

NASD; the Regional Exchanges; and the like, where they can make determinations on their own behalf.

At the present time, even these Exchanges have no access to any data of this type, and discussions as to the setting of rates and the level of rates within their own Exchange for that reason is somewhat theoretical and is not based on actual data and I hope that this is one of the situations which will be alleviated, at least in part, by my testimony today.

HEARING OFFICER FOSTER: Thank you.

THE WITNESS: Indeed, Mr. Michael Tobin, President of the Midwest Stock Exchange recognized the problem of the varied accounting techniques, and has suggested in testimony at these hearings that a uniform system of accounts be established for the industry.

Many witnesses at these hearings, have objected to the attempt to draw conclusions from lumping together of reports of all member firms filing Income and Expense Reports as looking at apples and oranges. One might feel safe in adding that there are also some watermelons, pumpkins and even a few lemons thrown in. The firms filing complete Income and Expense data for 1967 had security commission gross income ranging from a quarter of a million dollars to almost a quarter of a billion dollars. As of the end of that year, many of these firms had as few as two general partners while one firm had 181 voting stockholders. While some of the firms had only one office, one firm had 150 offices, some of them scattered throughout the world. Even more significant was the variance in the type of business done by these firms. Security commission gross income per transaction of these firms ranged from about $4 to over $500 and security commission gross income represented from 5 percent to over 100 percent of total gross income.

BY MR. ROTBERG:

Q Mr. Garil, when you refer to security gross income per transaction, range from $4 to over $500, would you explain what you mean by that?

A Right. On the I & E Report, the Exchange requires two types of information.

They ask, what was the total gross income received by this firm from security commission business, and I will explain later on exactly what is meant by that term.

They also ask for a transaction count. That is, the number of transactions done the entire year for that type of business.

By dividing one into the other, one can come up with an average transaction or an average income per transaction.

Q Would this mean, therefore, that for a firm to have an average transaction income out of the security commission business of say, $200, that the firm's average transaction was approximately 500 shares?

A That would be correct, but I think an average, which you would be talking about, would be a weighted average. The median or the middle transaction still might be 100 percent, but an awful lot of those smaller transactions would be offset by a few blocks of 100,000 or 50,000 shares.

Q And of course, the higher the commission per transaction, the greater the indication that the firm is concentrating on institutional discounts?

A That is correct.

MR. ROTBERG: Continue.

THE WITNESS: In order to make the data more useful, I have analyzed each of the 1967 Income and Expense Reports in an attempt to categorize the firms that filed them.

I think I ought to point out at this time, that even though we looked at the names of some of these firms, in a test as subjective as that, one runs certain risks.

It is difficult, in going to a firm and saying, what type of business are you in, because every firm has a different subjective viewpoint as to the type of business they are in and you may get two different firms and one would say they are in an intra-member business, and other is an institutional business, so what we decided on finally was to use a more statistically oriented measure and fitting groups into certain categories.

After this was done, we then checked them up against the names, and the names that were known to me at least, landed in the group that they logically should have fallen into.

The categories established included: a group of 120 clearing firms doing business primarily with the general public; a group of 95 non-clearing firms also primarily dealing with the general public; and a group of 24 firms dealing primarily with institutions. A fourth very large category of firms exists which might, using our apples and oranges analogy, be called fruit salad. These firms, in many instances, dealt with the public, while also dealing extensively with institutions, or doing large amounts of floor brokerage, or handling omnibus accounts, etc. Because of these varied types of business, these firms, in many cases, exhibited very conflicting attributes, such as having floor brokerage as their major source of income but also having very high income per transaction. The first three categories of firms that I discussed, are the ones which I will go into greater detail today. They have been chosen in that the number of firms with these conflicting attributes have been minimized. For instance, the two categories of firms dealing primarily with the public exclude all firms which received 10 percent or more of a security commission income from mutual fund lead brokerage, or 10 percent or more from floor brokerage and clearance. Those firms with 20 percent or more income from other intra-member business, such as handling omnibus and introduced accounts, were also excluded.

The reason that they were excluded was because of the difference in the non-member and the intra-member rate schedules. Firms that receive 10 percent of their security commission gross income from floor brokerage and clearance, or 20 percent from the handling of omnibus accounts, have a majority of their transactions in these segments of the business.

HEARING OFFICER FOSTER: That is because -- the reason that is true is because of the relatively small percentage of the fixed commission rate which is allocated to those specific functions. That is, in other words, the floor brokerage gets 10 percent.

THE WITNESS: That is right.

HEARING OFFICER FOSTER: Of the total commission.

THE WITNESS: That is correct.

HEARING OFFICER FOSTER: And the floor brokerage clearance is approximately 21 percent?

THE WITNESS: Yes.

HEARING OFFICER FOSTER: Thank you.

THE WITNESS: Those firms with security commission income per transaction below $25 and above $75 were also excluded from these two categories of firms.

BY MR. ROTBERG:

Q At this point, I would like to go back and discuss the three categories again.

A Okay.

Q I take it then, that the first category are clearing firms who deal with the public?

A That is correct.

Q The second category are non-clearing firms who deal with the public, and the third category are firms who deal primarily with institutions?

A That is correct.

Q With respect to Categories 1 and 2, may we assume that the reason that you excluded firms dealing with the public, all those who received 10 percent or more of their total security commission income from mutual fund lead brokerage, was because you believed that those firms more preferably fell into Category 3 -- that is, the institutional category?

A That is correct. It would appear that a number as low as 10 percent might still put someone in the category of dealing primarily with the public.

HEARING OFFICER FOSTER: This is gross income before give-ups, is it?

THE WITNESS: That is correct.

HEARING OFFICER FOSTER: Or is it after give-ups?

THE WITNESS: No, that is before give-ups. I think it should be pointed out however, that the I & E reports do not have any information which categorizes customers with the exception of mutual funds.

In examining this, we took this 10 percent figure and also these firms had to have that other attribute of a very large income per transaction.

MR. ROTBERG: We will get into that later.

BY MR. ROTBERG:

Q You also excluded from the first two categories of firms who dealt with the public, those who did 10 percent or more of their business from floor brokerage and clearance.

Do I understand that if that were the case, that because of the difference between the public rate and the intra-member rate, in excess of 50 percent of those firms' transactions would have to be between brokers as distinguished between themselves and a public customer?

A That is correct.

Q Could you tell us why it is -- excuse me.

They would basically be the so-called floor brokerage firms on the New York Stock Exchange.

Is that correct?

A Right. They would be floor brokerage, including specialists who may do some public business and file the report.

Q Could you tell us why a specialist or a firm broker -- for this purpose a firm who did in excess of 50 percent of their transactions with other dealers, would be filing the New York Stock Exchange I & E Report?

A There is no minimum amount or percentage of the business which requires one to file an Income and Expense Report. I think one of the first witnesses we had here, is required to file an Income and Expense Report -- that would be Pershing.

Pershing handles a comparatively small percentage of its transactions with institutions but even because it handles one or more, it fell into the requirement of those who had to file the I & E Report.

The same is true of specialists.

Q Is that because the requirement is that any firm that does any business with the public, must file an I & E Report?

A That is right.

HEARING OFFICER FOSTER: And the concept of "public" includes institutions?

THE WITNESS: That is right; other than another New York Stock Exchange member.

BY MR. ROTBERG:

Q Now, with respect to those firms, was the data which was presented by Dr. Freund, did it include in one category -- that is those who filed I & E Reports -- all of the floor brokers and all of the specialists who filed those reports?

A Dr. Freund's tables and his analyses included all filing members.

Q We have now commented on the firms who dealt with the public and why you made the breakdown that you have, in terms of separating out the floor firms and the institutional firms.

You also mentioned that you did not limit yourself to creating the institutional category from merely those firms which did at least 10 percent of their business from mutual fund lead brokerage, but also applied a security commission income per transaction test.

I note that you only included those firms in the institutional category who did both 10 percent of their business with mutual funds and had a $75 per transaction average security commission income.

Using those two categories, could you tell us how many firms fell into the general category which we can label primarily institutional?

A Right. There were 24 firms which were clearly institutional. Now, I think it should be pointed out --

HEARING OFFICER FOSTER: Did you use both? Did the firm have to satisfy both these tests or either one?

THE WITNESS: In all of these cases, the firm had to be pure in the sense that all of the standards were in there. There were many instances of firms -- and I think I could go back to Pershing again --

MR. ROTBERG: Why don’t you just answer the question with respect to the institutional firms?

Did they cinclude both the standard of over 10 percent with mutual funds and over $75.

THE WITNESS: That is correct.

MR. ROTBERG: Okay.

BY MR. ROTBERG:

Q I notice you excluded those firms with security commission income per transaction of below $25.00. When you say you excluded them, does that mean that they did not fall in any of the three categories: cleaning with the public; non-clearing with the public; and institutional?

A That is correct.

Q So they are not in these tables at all with respect to those three categories?

A That is correct.

HEARING OFFICER FOSTER: What was the reason for excluding those firms?

THE WITNESS: We had to choose a specific point at which firms could be classified as likely to be doing business under a non-member schedule and a point at which they would be doing business in the intra-member schedule.

Now, $25 was chosen rather artibrarily. There was no scientific reason for doing it other than a general round number and a range of $25 to $75. It is very possible that one or two firms might have been excluded erroneously and one or two firms might have been erroneously included.

HEARING OFFICER FOSTER: Excuse me. A $25 per transaction would be less than the whole public commission rate for stock which was selling at $40, is that right?

THE WITNESS: That would be correct.

MR. ROTBERG: Can you tell us --

HEARING OFFICER FOSTER: And therefore, a firm would either be doing primarily odd lots, which I assume you decided that there are not any that do that on the average, or would probably be doing floor brokerage because the floor broker gets such a small percentage?

THE WITNESS: That is correct.

HEARING OFFICER FOSTER: That was your reason?

THE WITNESS: That is the assumption.

BY MR. ROTBERG:

Q Do you know what the minimum commission is for a $10 stock of 100 shares?

A I am not sure.

Q Leaving that aside for a moment, at any rate the average price on the New York Stock Exchange is about $45 per share, and that is produced for a 100-share trade -- the smallest round lot -- a commission very considerably in excess of $25.

A That is correct.

Q So your $25 figure must mean that the firm had either been dealing with securities which were not listed on the New York Stock Exchange, because the price was so low or had to be getting this small commission because it was not doing a public commission business at the fixed minimum rates?

A That is right. The security commission business, I should say, includes exchanges and over-the-counter transactions, other than the New York Stock Exchange.

MR. ROTBERG: Why don't you continue.

THE WITNESS: At this time, I think it would be appropriate to submit for the record a bound volume containing some sixty scatter diagrams.

MR. ROTBERG: Well, I will mark this Garil Exhibit No. 1 and offer it into the record.

HEARING OFFICER FOSTER: Admitted.

(Garil Exhibit No. 1 was marked for identification and received in evidence.)

THE WITNESS: These sixty diagrams represent a small portion of many hundreds of diagrams which have been prepared under my supervision and which have been examined by me. The smaller number in the bound volume have been chosen in that they are illustrative of most of the concepts portrayed in the larger number of diagrams.

When I say “illustrative”, I think I should point out what I have done -- I will go into greater detail later -- is look at the types of business being done by the firms, and apply various measures of profitability. Now, because I have applied a particular measure of profitability to a particular segment of the business, there is no reason to assume that it could not be applied to the others. Indeed, the opposite is true, and this is the type of thing which I have excluded from this booklet. I have only applied, as an example, profit margin against the security commission segment of the business. The larger group of diagrams included it against security commission and margin and also for the total business. So each concept is illustrated within this booklet but the combinations of these concepts have been excluded and appear in the larger number of diagrams.

These diagrams should prove helpful in responding to the questions I have raised earlier. The diagrams depict for New York Stock Exchange firms the relation between various measures of profitability and measures of size and type of business. These measures are applied to different segments of each firm’s business as well as to the firm’s total business. A separate diagram appears for all reporting firms as well as for each of the three categories of firms.

BY MR. ROTBERG:

Q Mr. Garil, when you say “all reporting firms”, do you mean that in addition to the three categories that you have described, you also have a fourth category – all firms who file the I & E report?

A That is correct. I think for technical reasons, I should modify that in that certain firms have filed reports which are missing a few items, and because of that, we came up with a total of 356 firms, and the New York Stock Exchange reported that 375 firms filed the report. Most of those missing firms did not file the supplement to the I & E which is not mandatory.

Q Can you tell us, before you go into the details of the diagrams, whether the three categories of the firms, public clearing, public non-clearing, and institutional; can you tell us approximately what percent of the public security commission business they include?

A I don’t have an exact figure but I am sure that it includes more than three quarters of the business.

MR. ROTBERG: Okay.

THE WITNESS: We have almost all of the large firms.

MR. ROTBERG: Rather than come up with an estimate, can you supply us for the record, with the exact percentage which is covered by the three categories?

THE WITNESS: Yes, I will.

MR. ROTBERG: I will reserve Garil Exhibit No. 2 for that information.

HEARING OFFICER FOSTER: Okay. Garil Exhibit No. 2 will be reserved.

(Garil Exhibit No. 2 was reserved.)

THE WITNESS: In addition to the scatter diagrms, I would like to submit for the record a table which gives the range, the median and the mean for each of the measures of profitability I shall discuss today.

MR. ROTBERG: I will mark this as Garil Exhibit No. 3 and offer it for the record.

HEARING OFFICER FOSTER: Admitted.

(Garil Exhibit No. 3 was marked for identification and received in evidence.)

THE WITNESS: Since the diagrams and the table are in most cases self-explanatory, I shall not attempt to describe in detail what each of the diagrams depicts. I shall, however, comment on the concepts portrayed in each series of diagrams and point out some of the more interesting things I have found in studying them.

The first two series of scatter diagrams, those whose titles begin with Roman Numeral I and Roman Numeral II, depict measures of profitability for the security commission business as it is defined by the New York Stock Exchange for purposes of reporting on the Income and Expense Report. This very broad definition of the security commission business encompasses generally all agency transactions in stocks and bonds wherever executed. In recent years the New York Stock Exchange has taken the position that it is this segment of the total business, and only this segment, which is relevant to the determination of commission rate levels. Naturally, in order to examine this individual segment of the business, complex problems of allocating expenses to the security commission business and to the other phases of the business must be overcome. As any student of cost accounting knows, the allocation of expenses for any one firm is difficult and the results are at best arbitrary. Application of the same allocation formula to hundreds of firms as diverse as the New York Stock Exchange membership is at best far more arbitrary.

HEARING OFFICER FOSTER: May I interrupt at this point?

Are the Income and Expense Reports as submitted to the New York Stock Exchange required to be audited by independent auditors?

THE WITNESS: No, they are not.

HEARING OFFICER FOSTER: Thank you.

THE WITNESS: Nevertheless, since the only data available has been derived from reports using such a formula, despite its weaknesses and some of the questionable allocation derived from its use, the validity of the Exchange's allocations are assumed for the purposes of these diagrams.

I would like to turn now to the first series of scatter diagrams; that is, those with titles starting with Roman Numeral I.

If I may at this time, I think it would be helpful to point out how these things have been entitled.

The Roman Numeral refers to the standard of profitability or the measure of profitability and in each case it refers to the horizontal axis.

The Arabic Numeral refers to in each instance, the vertical axis which is either a measure of size or a measure of the type of business being done by each firm.

The letter refers to the category of firms which are so designated on the charts, A being all firms that reported; B being the clearing firms as described; C the non-clearing firms; and D the institutional firms.

The first of these diagrams shows the profit margin or return on sales from the security commission business. Profit margin, the measure of net profit after imputed partners compensation and estimated Federal Income Taxes as a percent of gross income, is the standard which the New York Stock Exchange has espoused in the past to determine the need for changes in levels of rates.

BY MR. ROTBERG:

Q Before you go into detail, I know you comment on this later, is it fair to say that profit margin as you are now defining it or as the New York Stock Exchange has defined it, is the bottom line income figure after taxes and after imputed partners' compensation, expressed as a percentage of total sales?

A That is correct. That is all for the security commission business in this instance.

Q That is correct. After the appropriate allocations have been made.

A That is correct.

Q So that it is the percentage -- if it were an automobile industry -- of gross sales of General Motor cars, as expressed, when compared to a percentage of net profit after taxes?

A That is correct.

Q It is not a return on capital or a return on assets at all?

A Not at all.

Q It has nothing to do with the balance sheet?

A That is correct.

Q It only has to do with a ratio of profits versus sales.

A That is correct.

Q And as such, only deals with the P&L statements?

A That is correct.

MR. ROTBERG: Continue.

HEARING OFFICER FOSTER: There is one qualification which occurs to me, which is that so far as I am aware, in the partnership in the automobile business, they would not publish an income statement after partners' computed compensation, but that they would just publish the income statement less what they have to divide up between the partners, so I think this concept of partners' imputed compensation might appropriately be explained.

MR. ROTBERG: Can you tell us why the New York Stock Exchange, and in the tables that you have presented, why you have and they have presented this percentage figure after imputing partners' compensation?

A In each instance, for each member firm, you have a variety. In some instances you have partnerships; in some instances, corporations. If one was to compare the partnerships and the corporations, a lot of erroneous assumptions would arise. What the Exchange has done, and I believe legitimately, to correct this situation, is to exclude all compensation to partners, actual compensation to partners or voting stockholders and according to a rate schedule, a compensation rate schedule that is, they have imputed compensation as if this was a corporation and they have also estimated Federal income taxes in an attempt to make each of these firms as comparable as possible in that final figure.

HEARING OFFICER FOSTER: Pardon me. They have done it according to a formula though, rather than an attempt to look at each firm and say, "This is reasonable compensation for these particular officers or partners", on the basis of what they do.

Is that correct?

THE WITNESS: They have not looked at individual firms but they have structured a level of compensation, in that there is one top man in each firm and he gets more than two or three second level management, and so on.

BY MR. ROTBERG:

Q At any rate, later in your tables, you will present data which will look at profitability in terms of the total return to all partners irrespective of the imputation?

A That is correct.

Q The only other point I want to make and ask you about now, is to ask you to clarify the point that profit margin is only on the security commission income part of the firm's business and is expressed as a percentage of the security commission income, not of the firm's gross income, and therefore, is being expressed after an allocation has been made to the security commission income versus other forms of income of the firm?

A Right.

Q Is that correct?

A That is correct.

Q So that, when we speak of profit margin at this point, we are only speaking of profit margin, profit of security commission income, expressed as a percentage of total gross security commission income, which has been derived after the cost account allocations have been made.

A That is correct.

MR. ROTBERG: Continue.

A The first diagram, Roman Numeral I-1A, shows profit margin along the horizontal axis ranging from minus 17 percent to 31 percent.

BY MR. ROTBERG:

Q When you say minus 17 percent, you mean minus 17 percent to plus 31 percent?

A That is correct. And I am now describing what is on the diagram. This is not the actual limit.

Gross income from the security commission business is shown along the vertical axis. Each asterisk on the diagram shows for an individual firm the point of coincidence of these two factors. In some instances, where there is a number rather than an asterisk, there are the designated number of firms with approximately the same profit margin and gross income from their security commission business. In some instances, firms with extreme profit margins, either high or low, are not shown because they fall outside the limits of the scale, and it would unnecessarily enlarge these limits to show them. The table, however, shows the ranges when all of the firms are taken into account. This first diagram shows that for all reporting firms, there is a very wide variation in profit margins. They range, as shown in the table, from a low of minus 24 percent to a high of plus 50.4 percent with a median of 6.9 percent.

Although the greatest variation in profit margins appears among those firms with gross income from the security commission business of under $5 million, those firms with gross income of over $5 million still have a range of profit margins of over 25 percentage points.

BY MR. ROTBERG:

Q For clarification, could you please for the record, read the appropriate vertical gross security commission business dollar figure.

A Right.

Q Because of the difficulty of the zeros.

A Okay. In each of the diagrams where we are dealing with absolute figures, we will limit it to a specific number because of computer problems and we have had to show how many digits have been deleted.

In this first chart, four digits have been deleted so that the lowest number of that above the zero, would signify 2,700,000 and the largest shown on the first part of this diagram would be 32,400,000.

Q Now, do I take it that the diagram on page 1 is continued on page 2?

A That is correct.

Q So that if these diagrams were to be really compared, page 2 would fit on top of -- that is, on top of page 1. That is, it would be over it?

A That is correct, with one modification.

Because of the tremendous difference in the size of the larger firms, it was necessary to change the scale on the continued part and this will be true in almost every instance.

Q I notice that on page 2, there is a figure 24600 representing security commission business.

Would you read into the record what that figure is in millions so that we have it clear?

There is one firm up there.

A It is approximately $246 million -- a quarter-of-a-billion dollars, approximately.

Q So we add on four zeros again, to that?

A That is correct.

MR. ROTBERG: Continue.

THE WITNESS: If we examine the 15 largest firms which are shown in the continuation of Diagram I-1A, we see that although the range of profit margins is narrower, we still have a range of about 12 percentage points; the profit margins of these firms however, are centered about the same point as the smaller firms.

BY MR. ROTBERG:

Q Are you saying that there is no significant difference in the firms who make between $2,700,000 and $5,400,000 and the firms who make something over $50 million?

A Right. That is correct.

Q In terms of this measure of profitability?

A That is correct.

Q By the way, when I said, make, I meant firms whose gross security commission business was approximately $2 of $3 million versus $50 million.

A Correct.

A comparison of the profit margin of the firms doing primarily an institutional business as shown in Diagram I-1D and the profit margins of the clearing and non-clearing members doing business primarily with the public as shown in I-1B and I-1C, respectively, is most informative. The median profit margin for the firms dealing with the public was around five and one-half percent while the median profit margin of the institutional firm is 14.3 percent, almost triple that of the firms dealing primarily with the public. Only 4 of the 24 institutional firms had profit margins as low as the median for firms dealing with the general public.

BY MR. ROTBERG:

Q Because of the way you have defined profit margins and the way the New York Stock Exchange has defined profit margins, for this purpose, is that a meaningful statement in terms of the profitability of the firms who do institutional business to the individual partners in terms of their capital commitments in those firms?

A In looking at this one diagram alone, you cannot make that assumption.

MR. ROTBERG: Continue.

HEARING OFFICER FOSTER: I would like to direct attention to the indication that a substantial percentage of the very small firms were doing business at a loss.

Do you have any explanation of 1967 being a fairly good year, of why they have continued in the security business, if they were operating at a loss?

THE WITNESS: I think it should be pointed out that this loss is after the imputation of partners' compensation. I think there is only one instance among all of the firms, where a firm actually lost money before the partners got one cent.

HEARING OFFICER FOSTER: So it is possible that some of the smaller firms are perfectly satisfied to do business if they can receive something less than the amount for partners which the New York Stock Exchange has assumed for theoretical purposes?

THE WITNESS: Right. I think this is a possibility, but I think it should be pointed out that the imputed partners' compensation is a very comparatively conservative figure, when compared to some of the real earnings which exist in the industry and which will be shown in a later diagram.

BY MR. ROTBERG:

Q Following up Mr. Foster's question, can you tell from looking at Table I-1A, whether some of these small firms, as a complete firm, lost money?

A No, you cannot.

Q All you know is that after the allocation of expenses to the security commission business, on that aspect of their business after the allocation, they came up in a minus figure?

A That is correct.

Q You do not know from this table whether or not the overall business of the firm showed a minus?

A That is correct.

MR. ROTBERG: Continue.

THE WITNESS: I think I should point out one thing in response to Mr. Foster's question. Where I said I believe there is only one firm which lost money before all imputed partners' compensation, I believe that was under total business. There might have been a few more which lost money purely in the security commission business. I don't have the actual number.

MR. ROTBERG: Continue.

HEARING OFFICER FOSTER: Thank you.

THE WITNESS: These higher profit margins are even more noteworthy when one considers that the Income and Expense Report considers give-ups as an expense. These institutional firms were able to enjoy these higher profit margins -- and as I pointed out earlier, they averaged almost three times as high -- even though they were giving up as much as 60 and 70 percent on certain trades. Assuming the New York Stock Exchange's past position is correct

-- that profit margin is the proper measure to use in determining rates -- then this diagram strongly emphasizes the need for a volume discount to bring about greater equality between the institutional and public firms.

Whether profit margin alone -- that is, without regard to total profits -- is the proper measure for determining rates, however, has been questioned. Although profit margin per se is not normally used elsewhere as a rate setting device, an operating ratio standard, the converse of profit margin, has been applied to the passenger bus and motor truck industries. James C. Bonbright in his authorative treatise, “Principles of Public Utility Rates”, points out that although such a standard has been applied, and I quote: “***the supporters have not yet succeeded in finding a convincing rationale for an operating ratio standard.”

Profit margins may have some validity for comparing firms within the industry. Just as one might compare the profit margin of Safeway to that of the A & P, one might be justified in comparing the profit margins of Merrill Lynch & Bache. One of the major reasons for a fixed rate, however, --

MR. ROTBERG (Interposing) Excuse me.

BY MR. ROTBERG:

Q When you say one might be justified in comparing Merrill Lynch and Bache, do you mean for purposes of rate regulation or for purposes of the two managers sitting down and comparing their own firms in terms of their relative efficiencies and operating ratios?

A In terms of the latter.

HEARING OFFICER FOSTER: If you were engineering a merger between the two firms, it might be one of the factors you might take into account? Is that it?

THE WITNESS: It might be one. I would think that others would be more important in that specific instance.

One of the major reasons for a fixed rate, however, is to encourage the continuation of resources in the securities business as well as to bring in new resources when necessary. Profit margins are not the determinants of the allocation of resources in our economy. Indeed, no rational being would leave the securities business to enter another business simply because the profit margin was higher even though the absolute income and the return of investment from the new venture would be lower than that of the securities business. In addition, no one has yet made a showing as to what a desirable profit margin is for this industry.

Diagrams I-2B and I-2D --

MR. ROTBERG: When you say "I", would you say Roman Numeral?

THE WITNESS: All right. Roman Numeral I-2B through Roman Numeral I-2D show for each of the three categories of firms profit margin as it is related to security commission income as a percent of a firm's total gross income from all sources. In each of these diagrams it appears that there is no pattern showing any relation between the proportion of a firm's income that comes from the securities commission business and the profit margin of that business. The New York Stock Exchange in its economic brief, which was presented in an earlier hearing, presents a diagram which is similar to Roman Numeral I-2A which showed this to be the case for all of the reporting firms.

BY MR. ROTBERG:

Q Let me direct your attention to Diagram I-2A.

Am I correct that the vertical axis is the percentage of security commission income expressed as a percentage of gross income?

A That is correct.

Q So, does this mean that for firms who do approximately half of their business -- I direct your attention to the 50 percent level -- in the security commission business, their profit marging range from about minus 15 percent to -- it looks like about plus 22 percent.

A That is correct.

Q And that this diversity of profit margins continues at every level of the chart on the vertical axis?

A That is correct.

Q So that irrespective of the percentage of the business which is security commission business, versus gross income, there is tremendous randomness or diversity in terms of profit margin.

A That is correct.

Q And am I correct that Tables 2B, 2C and 2D show this pattern generally occurring not only when all firms are included as in Type A but even for each of the individual three categories. Excuse me. Chart A.

A That is right.

Q Of firms. So that you have randomness and diversity for the whole sample as well as for each of the individual segments within it?

A Correct.

Q And conversely, apparently the same is true when you look at just profit margins.

For example, if you were to look at a 7 percent profit margin, you get complete diversity of the vertical axis?

A That is correct.

MR. ROTBERG: Continue.

THE WITNESS: We next turn to an analysis of profit margin as it is related to a firm's gross income per transaction. Diagram Roman Numeral I-3A shows that those firms having very high income per transaction, enjoy higher profit margins. Since these include the institutional firms discussed earlier, this should come as no surprise. The next two diagrams, Roman Numeral I-3B and I-3C, show this relationship for the clearing and non-clearing members who deal primarily with the public. It should be noted that among these latter two classes almost all of the firms suffering losses in 1967 had an average gross income per transaction of under $45.

BY MR. ROTBERG:

Q Do you have any further comment with respect to the diversity issue which I just addressed your attention a few moments ago, when the measure of firms is gross income per transaction. Does the same diversity and heterogeneity still exist?

A A similar pattern exists except, as I pointed out, when you get into the institutional firms, you have the diversity but the diversity is at a higher point and you nevertheless still have a very wide range between the high and the low.

Q Have you examined -- and you might want to comment on this later -- the percent of the security commission business which is done by the 25 firms showing the highest profit margins?

A I have not made a study of those particular firms.

MR. ROTBERG: Continue. We will go into that aspect later.

THE WITNESS: I would now like to turn to the next measure of profitability.

The diagrams with titles starting with Roman Numeral II show security commission net income after taxes as a percent of assets other than debit balances. The allocation of assets to the security commission business, was made on the basis of gross income. Naturally, if any return on assets standard should be considered for the determination of the reasonableness of rates, it will be necessary to develop sophisticated allocation techniques. In addition, the normal regulatory decisions as to the use of original costs, reproduction costs, etc., for certain assets, especially those fixed assets, would have to be made.

BY MR. ROTBERG:

Q Without at this time going into what your opinion is of the usefulness of talking about profits as a percentage of assets as distinguished from profits as a percentage of sales, can you tell us why you excluded debit balances in calculating the percentages.

A Since, in this instance, we are talking primarily of the security commission income and not the margin interest part of the business, there is very great distortion in that margin interest, the assets related to the margin interest business notably, the net debit balance is a very large portion and it is fairly -- they can fairly readily be removed from the picture.

If we were looking at assets for security commission in margin or total business, obviously, we would not have excluded them.

Q I think you should state for the record, that when we are speaking of security commission income up to this point, we are excluding all of the margin interest income and free credit balances because, under the New York Stock Exchange I&E Report, they are excluded for this purpose.

A They are excluded as a separate banking function completely unrelated to the securities business.

Q I take it in some of your later tables, you will include them?

A That is correct.

Q But up to this point, the margin interest income and the free credit balances and the profits derived from then are excluded; therefore, you also excluded the debit balances themselves in calculating the assets.

A That is correct.

MR. ROTBERG: Continue

THE WITNESS: For all reporting members, the median return on assets other than debit balances was 3.4 percent with the lowest return a negative 11.3 percent and the highest 26.2 percent. The return on assets other than debit balances for the larger firms, that is those with greater security commission gross income, was no higher than the return to those firms with lesser amounts of gross income. There was a much wider distribution of returns experienced by the institutional members as opposed to those members doing business primarily with the public.

BY MR. ROTBERG:

Q Do you have any comment as to why you believe that wide diversity occurred with respect to institutional firms?

A There is a possibility -- and I cannot substantiate that at this time -- that their need among the institutional firms, possibly is for greater assets because of block positioning and other things such as that, which the normal brokerage firm would not necessarily have.

The other thing is that these firms in most instances would not have debit balances to be excluded. Now, these firms usually are dealing with straight cash accounts and not dealing with margin accounts for institutions.

MR. ROTBERG: Continue.

THE WITNESS: The next series of diagrams, that is those titled Roman Numeral III, view the security commission business in conjunction with the income from interest on margin accounts.

BY MR. ROTBERG:

Q Before you get to that, am I correct that in Roman Numeral II, you have taken the same vertical axis as you have done for Roman Numeral I? That is, you defined the vertical axis in terms of gross security commission income; income as a security commission income as a percent-of-total income; and average commission per trade in the same way that you have done for Roman Numeral Category I?

A That is correct.

Q The only difference is that you are now using a different horizontal measure of profitability, return on assets?

A That is correct.

Q Why don't you now direct your attention to Category 3, which is a third measure of profitability?

A Section 19b(9) of the Securities Exchange Act --

Q You better re-read the first sentence.

A Okay.

The next series of diagrams, that is those titled Roman Numeral III, view the security commission business in conjunction with the income from interest on margin accounts. Section 19b(9) of the ’34 Act -- that is, the Securities and Exchange Act -- confers upon the Commission jurisdiction over exchange rules and practices related to interest charges as well as rates of commission. There remains the question as to how the two should be treated, for commission rate determination purposes, separately or as combined segments of the business. The New York Stock Exchange itself has been inconsistent in its treatment of the subject. Until 1953, the Exchange included interest income in its determination of profitability for rate making purposes. Indeed, the Exchange has used a decline in interest income as one justification for increasing the level of rates. In 1953, without any explanation, the Exchange reversed its policy and since that date they have excluded marin interest income from any enumeration of standards for the determination of rate levels.

The margin interest business by itself would not be very profitable if not for the huge volume of customers’ free credit balances available to help finance the operation. As of the end of October of this year, these free credit balances in margin and cash accounts of New York Stock Exchange members’ customers totaled more than $3.4 billion. This represented more than

55 percent of the $6.3 billion in customers' margin debt. Even if one argues that the actual financing of margin accounts is irrelevant, one cannot ignore the use, and in almost all instances the interest-free use, of customers' cash balances by member firms. Studies done here at the Commission show that returns from the security commission operations exclusive of margin lending but including the value of these free credit balances from security commission business, are higher than returns found when the margin business is combined with the security commission business.

HEARING OFFICER FOSTER: You refer to studies done at the Commission. Does this appear in your own charts here?

THE WITNESS: These charts -- this phenomenum is not shown in these particular charts.

The methodology used in determining the profit from, and the capital needed, in the combined security commission and margin operations is complex. Rather than taking time to explain the details of the procedure, I have included them as an appendix to the diagrams. As noted in the appendix, the methodology is very conservative and the returns on capital are probably understated.

The returns on capital for all reporting firms range from a negative 19.6 percent to 83.2 percent. The median for all firms was 14.5 percent. All but two of the fifteen largest firms as measured by gross income from the combined security and margin operations experienced returns above the median for all firms. The return on capital for these 15 largest firms can be seen in the continuation of Diagram III-1A. The return on capital for those firms doing an institutional business was also higher on average than the returns for all firms. The median return on the capital of these firms was 23.3 percent and two-thirds of these firms had higher returns than the 14.5 percent median of all of the reporting firms.

MR. ROTBERG: That table to which you just referred to is III-1B?

THE WITNESS: That is correct. Yes, sir.

BY MR. ROTBERG:

Q Can you tell us a bit further, before you go on, what you mean by return on capital?

A What I have done here, I will try to explain it in a comparatively simple form.

As I said, it is fairly complex and is described in the appendix.

We knew or we have accepted from the New York Stock Exchange, what the profit, dollar profit that is, on the security commission business for each firm is.

We know with a great degree of accuracy, the dollars involved in the margin interest received from customers. We have attempted to figure out for each individual firm what percentage of the margin debt was supported by free credit balances; and what percentage was supported by capital contributions of the members, partners, and the like.

A I said before, this was a comparatively conservative figure in that under Exchange rules as well as Commission rules, a 20-to-1 net capital ratio is permitted.

We have used a 12-1/2-to-1 net capital ratio, and that is based on the midpoint of the 10 and 15 which the Exchange has recommended to its members. We are able to get through this formula, the capital required in the business and the interest expense which would have occurred had the capital from the borrowings that would have been necessary. We subtracted this interest and expense from the interest income and after making certain modifications for commodities, margins, and the like, we come up with basically two figures.

We have the net capital necessary to support these two segments of the business and we have the income which is derived from these two segments of the business.

Now, as in the earlier case, we have imputed partners' compensation; we have included an estimated Federal income tax.

Q That is the point I wanted you to focus on; not so much what would enter the income side, but whether or not these figures represent a return on capital after the imputation of partners' compensation and after the payment of income taxes.

A That is correct.

Q So that what you have done in Roman Numeral III is retain the concept of imputed partners' compensation and retained the concept of the Federal income tax at approximately the 50 percent level, so that the figures you report here are net after those two calculations.

A That is correct.

Q I take it, in one of your later tables, you will show data prior to those two qualifications or exceptions.

A Yes.

MR. ROTBERG: Why don't you continue.

Strike that! I mean, I don't want you to continue.

So that when you show a 20 or 30 percent return on capital, that is after taxes and after partners' compensation.

A That is correct. This is the income which would be derived from the capital. It excludes any income that will be due to the partners for the actual work they put in. They are considered employees of a corporate enterprise for this purpose and the remainder would be analogous to the net income available to shareholders who are non-participants in the operation of the firm except that they have made a capital contribution.

Q If the firm has a tax shelter plan in oil or in real estate and they pay a lesser amount of taxes than 52 percent, would that show up on these tables?

A It would not, but for two reasons.

(1) The tax shelter plan would be another source of income. This only includes margin and securities; but even if we were looking at the total business and using this imputed compensation concept, we would not have this, and I think the converse would be true also in the sense that some of these partners being in a very high tax bracket, might pay a rate higher than the corporate income tax and to that extent, the figures might be understated.

MR. ROTBERG: Continue.

You were going to continue to describe some of the other sets of diagrams in Roman Numeral III. There also are two other sets.

THE WITNESS: There are also two other sets of diagrams in this series: One set, III-2A through D, compares returns on capital with the percent of a firm's total income derived from security commission and margin operations and another, III-3A through D, compares those returns with the average amount of capital devoted to that portion of the business.

BY MR. ROTBERG:

Q Can you tell us, with respect to the diagrams in Roman Numeral III, whether or not --- could you just tell us what kind of diversity or homogeneity exists? How would you characterize them in terms of return on capital?

A I think as was the case with profit margin, there is a wide, a very wide divergence between the firms; as wide if not wider than actually I should modify that -- it is much wider than in the case of profit margins.

The returns range, as I say, from minus 21.4 percent to 83.2 percent, which would mean for every dollar invested by the partners in this phase of the business, they had a return of 83.2 cents.

Q Does that heterogeneity exist both for the entire sample and for each of the individual three categories?

A Yes, it does. Obviously, to a lesser extent in each of the categories than the whole, but nevertheless, the range in every instance is very wide.

For instance, if we look at the clearing members, they range from minus 10.5 percent to plus 57.3 percent -- a range of 68 percent approximately. The non-clearing members, the range goes from minus 21.4 percent to 34.3 percent and for the institutional firms, we have a range of over 60 percent, from minus 8.7 to 72.2.

Q Have you examined what percent of the security commission business is represented by those firms who are in the highest 10 percent of the returns on capital?

In other words, if you were to take the top, say, 35 firms who represented 10 percent of the firms and their returns on capital, have you up to this point, determined what percentage of the security business these 35 most profitable firms do?

A I would say it would be a comparatively large percent but I would also like to say that most of those larger returns, the highest returns appeared among the institutional firms, once again.

Q With certain notable exceptions, which you will go into later?

A Right.

Q The reason that this question is important is because when you deal with what the appropriate minimum commission rate is, it is very crucial to know how any increase or decrease will affect firms who might be labeled an aberration in terms of their profitability but who might represent combined, 50 or 60 percent of the security commission business.

A Right. I think it would be notable in this instance to look at the continuation of III-1A which points out that the largest firm on the diagram has among the 15 firms that are portrayed on that page, the highest return on capital and if we look at that firm alone, which represents a very significant portion of the business, in any weighted figures which we may use, they have tremendous weighting, and any rate which was set including them or the other firms beneath them, as an individual firm, although it might not have that great an impact on the firms involved, the amount of customers involved would be very significant.

Q Are you saying that the largest 13 firms in the United States, which are shown on Roman Numeral III-1A, as continued, represent an income from the security commission business from $32 million up to $297 million?

A That is correct.

Q Have profit margins ranging from 7 percent after partners' imputed compensation and taxes, to over--well to almost 50 percent? 45 percent?

A That is right.

MR. ROTBERG: Continue.

THE WITNESS: Now, I would like to turn to the last two series of diagrams, which are Roman Numeral IV and V. These examine member firms as complete entities. The total business of any firm is not readily divisible into each of its elements. When a customer enters an office of a broker-dealer, should one say that the depreciation on the chair he will be seated in is a security commission cost if he buys a listed stock with the firm acting as agent, or that the depreciation should be classified as other costs if the customer decides to buy a mutual fund? Although this question might appear ridiculous, in reality it is thousands of these customers' decisions which determine the allocation of costs and the profitability of each segment of the business.

HEARING OFFICER FOSTER: May I interrupt at this point.

When you have been referring throughout your diagrams to security commission business, I take it that this does not include the spread from the sale of mutual funds?

THE WITNESS: No, that is excluded, and I think another thing which should be pointed out, are riskless principal transactions which may be significant, are excluded from the security commission business and are handled as trading in arbitrage.

MR. ROTBERG: You are speaking of over-the-counter riskless trades?

THE WITNESS: That is right.

BY MR. ROTBERG:

Q What about when a member firm block positions on an institutional account and thereby takes substantial risk. Do you know whether that is included as principal trading or as security commission income?

A It would be split up into two segments.

The commission he receives would be counted as security commission business. The profit or loss which is generated by that particular trade -- that is profit or loss from the principal – would be excluded and as has been pointed out earlier in these hearings, members themselves -- some of the institutional members -- will combine this and it is a very difficult thing to break out, when making these allocations.

MR. ROTBERG: Continue.

THE WITNESS: As long as members are obligated by the demands of their customers to offer services other than the straight agency business, it means consideration must be given to the totality of the business in determining the level of commission rates. Dr. William

Freund, Vice-President of the New York Stock Exchange expressed the fear earlier in these hearings that some firms might, to the detriment of others, be able to subsidize unprofitable commission business from profits attained elsewhere. Others have suggested the opposite; for instance, that subsidization of other segments of the business from high returns in the securities commission business is unwarranted.

Of the two standards applied to the total business covered by the series of diagrams, Roman Numeral IV and Roman Numeral V, I would like first to discuss that shown in Series IV -- return on assets. Naturally this standard suffers from most of the same weaknesses as the return on assets less debit balances discussed earlier. However, because these diagrams cover the total business, there is no need for allocations and any distortions resulting from the use of allocations do not exist.

As is the case with all the other standards discussed, the variation among all reporting firms as shown in Diagram Roman Numeral IV-1A is very wide. In this instance the returns range from minus 1.7 percent to a high of plus 24.6 percent. The median return is 2.6 percent. The institutional firms shown in Diagram Roman Numeral IV-1D again exhibit this very great variation with the large majority of the firms enjoying above average returns.

HEARING OFFICER FOSTER: When you refer to the median return on assets as being only 2.6 percent, is there any explanation as to why a business with such a low return on assets would be attractive?

THE WITNESS: I think in this instance, you will find that a lot of the assets are not backed by the capital of the firm. A large portion of these assets are debit balances of customers; whether it be in securities accounts, commodity accounts, and the like. So that this measure actually takes the return to the partners and measures it against an asset figure which includes not only their own assets invested in the business but the assets of their customers. It is included here more or less for illustrative purposes, and to bring out some discussion of these points as to whether it is an applicable measure or not.

MR. ROTBERG: In other words, one of the reasons the return is so low is because the return is going to the partners but it is measured against not only what the partners put in but what all his customers have put in.

THE WITNESS: That is correct.

MR. ROTBERG: Why don’t you go to the next stage.

THE WITNESS: The last measure of profitability shown in Diagram Roman Numeral V is gross income less total expenses per partner. This is the amount available per general partner before the imputation of partners compensation and the estimation of Federal income taxes. A further modification of this concept might take into account the average capital invested in the business by each partner. These diagrams do not take capital into account and the greater returns per partner of certain firms are due in part to the greater investment of the partners. The return to partners for all of the firms ranged from a loss for one firm of one quarter of a million dollars to a profit -- and that is an average profit -- to the partners of another firm of one and three-fourths million dollars.

BY MR. ROTBERG:

Q By that, you mean $1,750,000?

A That is correct.

Q Do you mean that each general partner, when you divided the number of partners into the profits of the firm, had $1,750,000 allocated to him?

A That is correct.

Q That is before taxes.

A That is before taxes or any compensation available to him because of any effort he put into the firm. This is the total amount available to him.

Q No matter how hard he worked or what he produced?

A That is right.

HEARING OFFICER FOSTER: This does not include an imputed partners compensation?

THE WITNESS: No, it excludes that.

HEARING OFFICER FOSTER: In other words, he has available to him the assumed base plus what appears on your table?

THE WITNESS: No. No. What this measures is that throughout the year incomes accumulated and expenses are paid out. At the end of the year, this is a remainder. Now, this remainder -- this makes the opposite assumption -- assuming this was a normal partnership, each of the partners would have available to them, assuming they split the pot equally, X number of dollars.

HEARING OFFICER FOSTER: This is an actual split rather than a theoretical split?

THE WITNESS: We do not know how much is re-invested in the business so we don't know what was actually taken out, but assuming they were to take all profits out of the business at one particular firm, the larger firm, it would have been able to take out $1,750,000 for each of its partners.

BY MR. ROTBERG:

Q Will you look at your Chart on the two-page chart and is that correct, that that is millions, or should it be thousands? Your table.

A No. I would like to correct that if I can, for the record. That should not be millions. It should be thousands.

Q Why don't you then read for us the means on the far right-hand column as to what the partners would have after subtracting from their gross income, their total expenses per partner.

A Right. Now, this is assuming that the partners were to split up equally, the mean for all partners -- and this includes all firms -- would have been $154,000. For those firms which did a security commission business -- let me modify that -- which did business with the general public and with clearing firms, the split would have been approximately $133,000.

For the non-clearing firms, approximately $78,000 and for the institutional firms, $337,000.

Q The second column from the left, I take it, is the high range for each partner for categories A, B, C, D, and the low range is shown on the far left.

A That is correct.

MR. ROTBERG: Why don’t you continue and then we can go into detail on some of those charts.

THE WITNESS: The average income per partner of the median for all firms was over $100,000. The clearing firms doing business with the public had a median of $107 thousand while the non-clearing firms, generally smaller in size, had a median of $67,000. The firms doing primarily an institutional business had income per partner -- that is, average income per partner -- of about $224,000. As Diagrams Roman Numeral V-2A through Roman Numeral V-2D show the firms with greater capitalization enjoyed the greater returns per partner.

BY MR. ROTBERG:

Q I do want to go through some of these tables with you.

Which kind of firms do most security commission business? Non-clearing firms or clearing firms?

A The bulk of the dollar volume is done by the clearing firms. They are larger firms.

Q That is shown on Table Roman Numeral V-1B?

A That is correct.

Q Yes. That is a continuation chart, is it not?

A That is. It is continued on the next page.

Q Am I correct then that for firms who do more than $24 million worth of business per firm that no partner makes less -- I don't mean to add anything by the word "makes" less but no partner -- as you defined it -- would have, after subtracting expenses, income available to him of less than $80,000?

A That is correct. I think one point ought to be made. Like in any other business, the partnership distributions would not necessarily be equal. One partner in this particular firm might have gotten a million dollars and the rest $20,000; but if we assume what the average is, it would come out to somewhere over $80,000 and it is closer to $100,000.

Q I notice that one firm did $390 million worth of business. Is that correct?

A That is correct.

Q And may we assume that the average income per partner of that firm, which is the largest on your chart, is somewhere between $720,000 and $800,000 per partner?

A It appears to be around the $720,000; possibly a little more.

Q Is it fair to say that from Table 1B, that the firms who do the most business, security commission and other business, have the highest returns per partner?

A The table certainly gives that appearance.

Q I want to direct your attention now to the institutional firms which are shown on V-1D, which is also continued.

I notice that there are four firms whose average income per partner is between $720,000 and it looks like around $950,000.

I take it that these are the four largest institutional firms in the United States.

A I would say that they are four of the five. There is a fifth one which has a much lower --

Q (Interposing) Now, I notice that the returns of those five firms represent firms which do between -- it looks like about $30 million and $85 million gross business per year.

A It would be closer to $100 million.

Q Between $35 million and $100 million per year?

A In that general area.

Q And that these returns per partner, are substantially higher than the public clearing firms who do not primarily do institutional business?

A Yes.

Q Those firms, their per-partner income is something closer to $100,000 to $400,000.

I refer to Diagram V-1B continued.

Do you have any explanation of why the income available to the institutional partners would be about double those for non-institutional firms, for the same overall dollar volume of business?

A Without going into a detailed analysis, I don't think I could.

Q Is it fair to say, however, with respect to the institutional firms that the figures that you show here are after these institutional firms have given up their give-ups?

A That is correct.

Q And these are the returns after give-ups?

A That is correct.

HEARING OFFICER FOSTER: Is there any problem, in evaluating these institutional firms, in taking into account the possibility that some of their profits may be -- a substantial portion of their profits -- may be from underwritings, and to a degree, to a greater degree than the firms that deal with the public?

THE WITNESS: I think that could be answered by looking at -- going back to our first series of I-1A which will show that if you look at -- I will modify that -- Diagram I-2B and 2C, which shows the percentage of income from the security commission business for the clearing and non-clearing members doing business primarily with the public, and then looking at 2D. I think the range appears to be much wider for the institutional firms, but nevertheless, there are some firms which have a very high percentage, almost 100 percent of it, coming from the security commission business as described earlier, and some of the firms being comparatively low.

I think some of this low figure comes from the fact that some of these firms are significant, as you say, underwriters and some may be in municipal bonds and the like, and do a large institutional business in securities other than on an agency transaction. They may deal exclusively with institutions, but not in the security commission business as described.

BY MR. ROTBERG:

Q Let me direct your attention to Diagram Roman V-2B.

You will note that the range between zero and a quarter-of-a-million dollars per partner; firms with capital and subordinated accounts, between zero and I guess that is $10 million in the lower left-hand corner --

A Yes.

Q Yet it seems that if you look at the capital and subordinated accounts for the institutional firms in the same category, zero to $10 million, that the profits per partner are much higher.

Do you have any explanation why the firms who do institutional business and have the same amount of capital commitment, end up with much more dollars per partner?

A I think the answer to that is fairly obvious, in that the cost of doing an institutional business probably presents a much lower ratio of the total income from that business.

In other words, we have shown earlier the profit margins are that much higher and probably result from the fact that when these tables were prepared, or at least, the data that they are based on, was based on a rate schedule which did not have a volume discount.

Q Well, even with the same amount of capital they are making far more money than other institutional business.

A That is correct.

Q Except for the very large five institutional firms, which have very substantial capital, which may or may not be used in the security commission income business, and whose income may or may not be from security income, whose returns are very substantially higher.

A That is correct.

Q I do not mean, by the way, when I use the word “return” to mean anything other than what you have described. It is the amount available to partners before taxes and irrespective of what his commitment is to the business, and irrespective of what he does in the business.

A Yes.

Q Now, would you make onefinal comment as you analyzed these last No. 5 series tables, as to whether or not the same heterogeneity exists, irrespective of the size of the firm; particularly with respect to the firms doing a public non-institutional business who are clearing firms.

A Right. There is, once again, a degree of heterogeneity. It does not show up probably as widely on the diagram as some of the earlier ones do, simply because of the base. There are so many firms which are making very high -- comparatively high average gross income, less total expenses per partner, that the larger number of firms that are making under a quarter-of-a-million dollars are so squeezed together, but obviously the range, I think, is between zero and $250,000, which is in itself, a very broad range. The great bulk of the firms are spread out fairly evenly within that range.

Q Again, have you at this point, taken the top 25 firms in terms of the amount available to partners, and calculated what percent of the security commission business these 25 firms do?

A I have not calculated the exact percent, but there is a diagram that shows the firms with the larger gross income tend to have the largest income per partner.

Q On one of my last days in the Commission, I will ask you to present -- and I will mark for the record Garil Exhibit No. 4 -- a table which will take, for each of the five Roman Numeral categories that you have presented, the top 25 firms under each measure, and indicate in that table, what percentage of the securities commission business is done by those 25 firms.

A Right.

(Garil Exhibit No. 4
was reserved.)

Q Now it may be that you would want to go further and take the top 50 and the top 100 on a regular frequency distribution. I suspect that that is indispensible to determine how any change in rate level would affect not only those firms but how any change which would affect, say the most profitable, say, 25 firms, what the impact would be on the public as measured by the extent to which those firms have the greatest exposure to the public.

A Right. I will prepare such a table.

MR. ROTBERG: Thank you.

HEARING OFFICER FOSTER: This table, I think would be based on -- like your others -- on only those firms which have filed the New York Stock Exchange I&E Reports.

THE WITNESS: That is correct.

MR. ROTBERG: Yes.

THE WITNESS: The one thing that emerges most clearly from analysis of all of these diagrams is that there is a great degree of heterogeneity in the structure of the industry. Not only are firms diverse in size and in the types of business in which they are involved but they also exhibit great diversity as to the returns they enjoy. In part the difference in returns is due to an emphasis on different types of business. Firms dealing with institutions and other large customers have been able to take advantage of an inequity in the rate structure to realize far greater returns than those firms dealing with smaller investors. Within categories of similar firms there is still great diversity. Where such diversity exists it is necessary for those responsible for the setting of rate levels, to concern themselves with one additional matter. After choosing a rate base and a desirable return on that base, the rate setter also must determine which firm or firms are to receive that return and which are to receive higher and lower returns. Should the level of rates be set at such a low point that practically all firms, regardless of their efficiency, receive at least the chosen rate of return? Or should the determinant be the median firm, or one of the firms now enjoying above average returns? More important than the actual statistical measure, be in mean, median, etc., should the impact on individual companies be a prime consideration? Can a rate which gives a very small minority of the firms unreasonable profits be reasonable if these few firms do a substantial portion of the business. And I think the diagram or the table which I will prepare, will address itself to that particular question.

These questions are complex. The Department of Justice has argued that they are so complex that the effort involved in determining reasonable rates of commissions cannot be justified if the alternative of determination by competition is available. It is not for me to say whether the effort is justified. As one who has worked on these problems for many years, however, I am well aware that there is no easy resolution of the problem. I will feel some sense of accomplishment if my testimony today will encourage others, both within and outside of the securities industry, to address themselves to these problems at a later date in these hearings.

Thank you.

MR. ROTBERG: I have one other question which refers to an earlier part of your testimony.

BY MR. ROTBERG:

Q You indicated that you have, I believe, some five or six hundred additional tables of a type that you have just presented in these bound volumes.

Is that correct?

A I don't know if it is five or six hundred but there are many hundreds.

Q Now, may I assume that they are additional measures of profitability other than the five that you just presented?

A They include, as well as additional measures, the application of these measures to different segments of the business.

For instance, profit margin would be applied to total business; securities commission and margin as well as to the security commission business alone, as in these limited number of charts.

Q So that there are an infinite number of measurements of capital of the different segments of the business, and there are also additional categories of firms, other than the four we spoke of?

A No. As a matter of fact, the greater number does not include all firms. It only includes the three categories of firms.

Q I take it that those tables are not complete or finished for various technical reasons, for submission into this record?

A That is correct.

Q Would you be prepared if a request was made of you, to supply to any interested person, a particular measure of the profitability, assuming that you have it in your computer, as against these three categories of firms?

A Yes, sir, I would.

Q And if further work is needed to get that particular table in shape, for such request, would you be prepared to offer those particular table or tables, if such a request were made of you, into the record?

A Yes, I would.

HEARING OFFICER FOSTER: I should think that it would be subject to some judgment as to relevancy. I take it that you feel that, based on your own analysis up to this point, that the particular charts that you have selected are sufficient to illustrate the points that you have made and if someone else wanted to use other charts to illustrate some other purpose, it would be up to him to justify the relevancy and that we would not suggest to him the possibility that some curious person would just have to have them all dumped into this record.

THE WITNESS: I think not only the relevancy of the chart, but of the request. I would hate to be writing everybody's Masters thesis next year.

MR. ROTBERG: I am reminded of one other thing.

In your testimony, you gave by way of an example Pershing Company, which you indicated did a comparatively small amount of its business with the public. Excuse me. Which you said did a comparatively small amount of its business with institutions.

Did you mean that Pershing does not do a public business or that Pershing does very little institutional business?

THE WITNESS: What I meant by that was basically the transactions of Pershing. I believe I used that as an example of some of the mixtures that occur, and while Pershing does primarily an intra-member business, and considers itself an intra-member firm, in those instances where it might get a non-member commission rate, it would completely distort the dollar value. So you have to look at both -- in looking at a firm, you have to look at dollars as well as transactions, and this is what that ratio that I tried to draw up accomplishes.

MR. ROTBERG: And of course, the other exhibit to which we referred is the exhibit which shows what percentage of the security commission business you cover by these categories of firms.

THE WITNESS: Right.

MR. ROTBERG: Thank you very much. I appreciate your testimony and I am sure that the Commission will find it quite helpful.

THE WITNESS: Thank you.

HEARING OFFICER FOSTER: The hearing is adjourned, subject to call.

(Whereupon, at 12:05 o'clock, p.m., the hearing was adjourned, sine die.)

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