BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 29, 1971

To Chairman Burns

From John D. Stoffels

Subject: Subsequent contacts regarding revised commission rate schedule.

Since our discussion of this subject on Tuesday, I have obtained additional data from the SEC and discussed the commission rate proposal in some detail with officers of two brokerage firms. One contact was Bill Grant, Vice Chairman of Smith, Barney and the other a vice president of Shields & Company who was formerly with the New York Reserve Bank and whose judgment I respect. Both of these firms split their business about evenly between institutional and retail trading. What follows is an interprative summary of their comments.

There were two dominant themes in the comments of both men. First: confusion. Brokers in general are confused as to the meaning of negotiated rates on large trades. Negotiation of commission on each trade for each customer (neither thought that would be possible because of the speed with which the business moves), negotiation of a single rate for all the trades of each customer (would there be anti-trust implications of varying rates among customers), or negotiation of uniform rates by size of trades for all customers (would that truly be a negotiated rate)?

Second: uncertainty. What possible legal consequences might there be if the major block trading houses all arrived rather

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quickly at the same (reduced) rate of commission on large trades? How will firms providing research and trading services be compensated for their research if they must compete on rate with firms that are geared only to execute orders? Will the small regional brokerage firm survive?

Both of these themes appear to be natural by-products of the fact that the proposal would replace the traditional fixed price environment, and all of the structural accomodations associated with that environment, with a new competitive pricing environment in which these structural accommodations are no longer appropriate.

For example, over the years, and because of the fixed commission schedule, it had become common for mutual funds to compensate small firms for research or mutual fund sales by directing the broker executing their trades to give up part of his commission through direct payment to these small firms. When give-ups were abolished in December 1968, the same system continued on a somewhat smaller scale (in a legal but technically limited manner) among exchange member firms, and non-member firms were compensated through reciprocal business agreements.

These arrangements will not work under a competitive commission system, simply because the trading broker will be compensated for only his trading activity; he will have no "fat"

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from the fixed commission to allow him to spread commission dollars among brokerage firms. But what will work under a competitive pricing system is that mutual fund sales, research expertise, and other services will be competitively priced and charged separately. Indeed, small research firms and regional brokerages concentrating in mutual fund sales may be expected to prosper more under the competitive system than under the fixed price system, because it will become common within the industry for institutional investors to compensate firms directly for any non-trading services that they provide.

Conceptually, both men agreed that this was the likely course of change in response to negotiated rates on large trades, but both men also expressed uneasiness over the short-term impact of the process of change. Both saw large trade commission rates declining, and both saw some possibility of a near term impact on the liquidity of large order trades and on the availability of resources for quality research.

Neither discussion yielded any strong concern that the approximately $450 million in additional revenue for firms concentrating in smaller transactions was insufficient to make the retail firm financially viable. In fact, the Shields contact suggested that the small order rate increases in the original NYSE proposal were excessive and should have been scaled down.

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The Shields contact confirmed as "reasonable" the SEC's finding, reported in the earlier memorandum, that about 40 per cent of large order commissions are presently given away in one form or another by brokers executing these trades. He did indicate that most of this percentage was accounted for by payments made to other NYSE member firms as part of "same-day substitution give-ups."

Please note one correction to be made in the earlier memorandum. I estimated that, under the new commission schedule proposed by the SEC, a firm that concentrated its business entirely in orders covered by the fixed-commission schedule might increase its revenue as much as 40 per cent. Based on data subsequently obtained from the SEC, I have determined that the approximate average increase in revenues for such a firm would be 31 per cent.

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