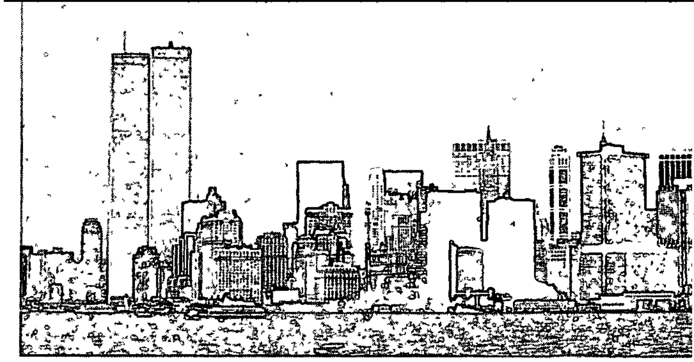
PERSPECTIVES ON PLANNING

THE New York Stock Exchange[SM]



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PLANNING FOR COMPETITIVE COMMISSION RATES

On September 11, 1973, the Securities and Exchange Commission announced its decision "to terminate the fixing of commission rates by stock exchanges after April 30, 1975, if the stock exchanges do not adopt rule changes achieving that result." In addition, the SEC specified that, if the higher fixed commission rates also approved in September, 1973 are to remain in effect after March 31, 1974, the NYSE must adopt several rule changes to ease the transition to fully competitive rates.

One change would eliminate part of NYSE Rule 383 prohibiting member organizations from charging investors commissions exceeding the current fixed commission rate schedule on small orders. In effect, this would allow brokers to increase rates on small transactions, without offering any additional services to investors. A second change would terminate the fixing of minimum commission rates by the NYSE on public orders below $2,000. These rule changes, if adopted, would provide member organizations a minimum of one year to experiment with flexible pricing before fully competitive commission rates and unbundled services take effect.

The following broad discussion aims at stimulating management to prepare to meet the problems and opportunities of a competitive rate environment. In gearing up for competitive rates, it is essential both to assess the demand for brokerage services and to determine the cost of providing them to investors. This paper provides some of the techniques that can help member firms develop their own programs to reach realistic pricing decisions.

Counsel for the Exchange have suggested that the following information be brought to the attention of member organizations.

> The elimination of Exchange rules fixing minimum rates of commission to be charged by its member organizations will mean that the Sherman Antitrust Act's prohibition against concerted price-fixing will be fully applicable to Exchange member organizations. Under the Sherman Act, the fixing of prices or rates by arrangement among competitors is per se illegal, i.e., is illegal regardless of whether the motives of the participants are good or bad, whether the prices or rates fixed are reasonable or unreasonable, whether the effect of the arrangement is to raise or lower prices or rates, and whether the amount of commerce affected is large or small. The proscribed rate-fixing does not have to be accomplished by express agreement in order to be unlawful.
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> The Supreme Court has held that even though there is no agreement, express or implied, to charge the same price, concerted action sufficient to establish a price-fixing combination or conspiracy exists where there have been exchanges of information among competitors concerning the most recent prices charged or quoted and the result of such reciprocal exchange of information on prices is to stabilize prices, whether upward or downward. Therefore, while it may not be unlawful to charge the identical rate charged by a competitor or to follow the rate leadership of large member organizations, each member organization will have to obtain information as to rates quoted by competitors from sources other than the competitors themselves or the Exchange and will have to fix its own rates independently.
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> It is suggested that each member organization should consult with its own legal counsel in making its decisions concerning rates to be charged after the elimination of fixed minimum commissions.

DEMAND FOR BROKERAGE SERVICES

A brokerage firm's revenue from securities transactions today depends basically on the number of trades it executes at a fixed industry-wide price (for transactions under $300,000), regardless of the amount or type of services it provides clients. Thus, competition currently is based not on the price of the service but on services included in the price. In an environment of competitive commission rates and unbundled services, however, the price of a service will become a new element in the demand for the service. Firms will be examining the interrelations between cost, price, and revenue as another element in a multi-dimensional marketing program.

Elasticity of Demand. Knowledge of the elasticity or price sensitivity of demand for brokerage services is an essential ingredient in determining price. The price sensitivity for an individual firm's brokerage services will be determined by each client's view of the uniqueness and importance of the firm's services, and his awareness of the cost of obtaining the same or similar services elsewhere. Response to price differences will vary among different types of existing or potential clients—from high sensitivity to almost total insensitivity. Reactions will also vary with the mix of services offered and from one geographic market to another.

The concept of the price elasticity of demand may be illustrated by a hypothetical problem which has, at times, confronted the New York Stock Exchange, during the period of fixed rates. It has been suggested occasionally that on round-trip transactions, where the buy and sell sides are completed within thirty days, a commission discount of, say, 33% be granted. To make up for the one-third reduction in revenues, demand would have to be elastic enough to generate a 50% rise in commissions. Such a rise would not be sufficient, however, to cover the added costs incurred in handling the larger number of trades.

Trade-offs. Investors' views of the relative worth of various brokerage or brokerage-related services, should be carefully considered in determining prices. The "trade-off" method of assessing demand is based on consumer-choice behavior in which investors select various brokerage service concepts and components of these services which they believe will aid their investment decision-making. In choosing among brokerage services, the investor trades off one kind of service for another, or one level of service for another. For instance, he may choose to forego some research services to obtain a lower commission rate; or conversely, he may be willing to pay a higher commission in order to obtain additional research. He may also trade off some research for a higher level of custodial service. In each instance, he will try to allocate his resources to obtain what he regards as the best value.

A recent Exchange marketing research study[1] analyzed small investor trade-offs, examining the relative values small investors placed on various brokerage and brokerage-related services. Among the services analyzed were execution, investment counseling, personal contact with a registered representative, and custody of securities. Each service was presented to investors at three quantity or quality levels. (For survey purposes, commission rates were set at the standard rate in effect during 1972, and 10% below and above that rate.) It should be noted, however, that investors with high incomes and/or active investment patterns would probably make different value judgments about the relative importance of various brokerage services based on different needs. Nevertheless, firms with retail accounts may want to examine the results of the study.

Experimentation. A method that will be relatively new to securities firms in determining the demand for brokerage services is experimentation with both price levels and service packages under actual business conditions. Once past the concept stage in developing a price schedule (probably the most difficult aspect), the technique of test marketing offers the most reliable method of measuring demand for products or services under actual conditions. The results of a test market experiment can then be projected to the total market for the service.

Most test marketing techniques involve using a number of different geographic areas (usually metropolitan areas) or branch offices where changes in price, service bundles, and marketing efforts can be tested concurrently. The number of test markets utilized will vary with the number of prices and service combinations to be tested.

The firm's pricing strategies, however, should be thoroughly analyzed before test marketing is undertaken—to avoid testing a mix of services that may later prove unacceptable in bookkeeping or operational terms for the national market.

Substitution Effect. The substitution effect in the demand for brokerage services is introduced when investors can obtain the same or similar services from other suppliers either within or outside the brokerage community. The competitive availability of services complicates the pric-

[1] NYSE, *Marketing Securities to the Small Investor*, June 1973.

ing profile of the market, and reactions will vary among different types of investors. An example would be the value attached to custodial services by investors. If a brokerage firm decided to unbundle its custodial service, the service would then compete, in some ways, with safekeeping services offered by banks. Similarly, an investor now receives research under fixed commission rates. In the future, he may choose to shop for research among outside suppliers or other brokerage firms, as a possible alternative to the firm executing his transaction. Firms should decide, therefore, whether they want to compete on the basis of "uniqueness" of services (service bundles) or on the basis of price, or a combination of the two.

COST OF BROKERAGE SERVICES

Constructing a cost schedule of a particular brokerage firm and each of the services it offers to clients is a difficult task. Most firms have reasonably accurate knowledge of the average cost of processing a transaction, but no more than a rough estimate of the costs of offering a mix of brokerage services at various transaction levels. Few firms have made a serious attempt to develop these data; and where efforts have been made, the difficulties involved in generating accurate and usable data have cast some doubt on the reliability of the results. In preparing for the advent of competitive rates, however, brokerage firms must attempt to develop more meaningful benchmark estimates of cost.

In developing a cost schedule, a firm should be aware of the problems which can arise from changes in the determinants of cost (overhead and employee expenses, techniques of processing transactions, etc.) while a cost study is underway. In any particular period, costs are affected by stock market volume and the rate at which transactions are processed. A sudden volume increase will cause a sudden disproportionate decrease in short-term unit costs. Changes in the mix and size of orders may also materially affect costs for some firms. Finally, since most brokerage firms provide more than one product and service, the relative importance of the various services in the mix is likely to change as the investment climate changes during a given period.

Accounting Costs. The accounting cost approach attempts to show how a brokerage firm is performing from a financial or tax standpoint. Typically, accounting costs conform to strict rules, designed primarily to assure formal comparability among time periods and among member firms, and to facilitate verification by Exchange examiners. On the other hand, estimates of "decision-making" costs aim at giving management a clearer understanding of the future implications of present actions rather than determining what happened in the past. From its accounting costs, then, a firm can determine if it has a problem, while a decision-making cost approach enables the firm to develop alternative remedies.

Decision-Making Costs. A firm planning to introduce a pricing program must decide among several alternative strategies and assess the likely effect of each plan on future profitability. A number of factors should be considered in developing reasonable estimates of decision-making costs. The first requisite is a precise description of the alternative marketing programs that could be implemented. This requires a thorough analysis of the existing situation and the opportunities open to the firm. Flexible classification of accounting records is also needed, so costs can be categorized in meaningful terms within alternative plans. Meaningful decision-making cost estimates can be generated from traditional accounting records only by reclassification, deletions, and/or additions to fit the cost concepts relevant to the pricing problem at hand. For most brokerage firms, decision-making costs will usually be quite different from those reported by conventional accounting systems.

The variety of cost techniques that management can utilize in its decision-making will depend on the firm's accounting system. It would be prudent, therefore, for each member firm to begin now to develop an accounting system flexible enough to generate both accounting costs and decision-making costs that will be needed in reaching pricing decisions. The sooner a firm implements a new accounting system, the better prepared it will be in the future to make comparisons of pricing alternatives by manipulating a larger, flexible, and more meaningful data base.

THE PRICING DECISION

In addition to determining the various factors influencing demand for brokerage services, attention should be given to measures which can improve demand. To develop a successful price schedule, a firm will not only have to know the values different client segments place on brokerage services but also investor reactions to price changes for the firm's services. No industry or company has yet developed a completely reliable method to measure price sensitivity of demand for its products, let alone for a complex mix of financial services. Moreover, the specific responses of competitors to future price and non-price actions obviously cannot be determined today. To cope with these difficulties, a firm should attempt to develop a formal decision-making framework to guide its analysis. This would not only encourage systematic thinking, but would also set the structure for testing various price levels while monitoring possible competitive responses to the firm's decisions.

A Monitoring System. A firm's pricing difficulties and opportunities are directly related to its overall objectives. Potential pricing objectives can vary from growth and maximum long-term profits and return on capital to enhancing the image of the firm and the services it offers to investors in the short run. Prices and price changes do not simply affect current revenues; they have far-reaching effects on a firm's longer-term financial performance. To identify potential pricing problems, a firm should develop monitoring systems for tracking accounts or groups of accounts whose activity, quality, and location are thought to be representative of the firm's business.

The initial step in developing a monitoring system of this type would be to array the firm's accounts by activity, the commissions they generate and the services they consume. This distribution will serve as a benchmark from which a sample can be selected to profile customers whose activity can be tracked over time. As noted earlier, firms should also begin to develop flexible accounting systems designed not only for financial analysis but also for marketing decision-making. Under the direction of a "marketing controller," an effective accounting system could serve as an ongoing monitoring system and an early warning indicator of unsatisfactory business conditions in specific profit centers.

Alternative Pricing Programs. In addition to varying its price levels, a firm could combine price changes with other marketing actions. A firm could, for example, alter in various ways its service "package" or its advertising. The introduction of an account maintenance fee could be combined with changes in commissions rates and clearing charges.

The most effective solution to a pricing problem—or the best way to handle an opportunity—will rarely be simple price change. The most successful marketing program will try to capitalize on clients' different perceptions of the various services offered by a firm.

ROLE OF THE REGISTERED REPRESENTATIVE

The registered representative is an important, if not the most crucial, element in most firms' marketing efforts. Typically, in the past, the registered representative has been expected to serve the needs of all types of investors, and many firms have focused their marketing strategies on the salesman rather than on the customer. Not all investors, however, require the same kind of service or the same type of registered representative to handle their accounts.

An environment of competitive rates and services may require different types of professional levels of registered representatives for different types of clients. Three levels of registered representatives could conceivably evolve: a service representative handling only unsolicited orders; a registered representative who functions much as he does today; and possibly a senior registered representative acting as an investment advisor serving clients who want account management. Each level could serve as a training ground for the next, with clients obtaining the type of service that meets their particular needs, while firms utilize their manpower more efficiently.

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CHECKLIST

The foregoing discussion is intended merely to encourage NYSE member firm managements to begin actively considering the opportunities and problems which will confront them when competitive rates go into effect. Future Exchange publications will deal more specifically with many of these topics.

To stimulate further management discussion and planning, the following checklist outlines some of the major policy questions member firms should be considering as they prepare for competitive rates. Individual firms, of course, may find it helpful to modify or expand this checklist to reflect their own situations and business orientation.

What services does your firm currently provide to investors? Which services do you consider most important to your firm's profitability? Are your firm's services more attractive to investors than those offered by your competitors?

Under competitive rates does your firm intend to provide all the services it now provides to clients, or does the firm intend to specialize in select segments of the financial services industry?

Has the firm identified its current client "mix" and determined what types of clients it wants in the future?

Can management currently determine the service needs of the firm's clients by investor segment or customer type? Does the firm have a formal or informal monitoring system to determine when and how these needs will change?

Do your clients obtain financial services from outside your firm or even outside the brokerage community? To what extent and what type of services do other institutions, such as banks, supply your customers? Is there a unique type of client who wants these services? Can your firm repackage these services to make them more attractive or economical to clients?

Does your firm intend to unbundle some or all of its services? Which services can be operationally unbundled without alienating investors?

Does the firm intend to expose groups of accounts to different forms of services and service packages while tracking their responses during the interim period between April 1974 and May 1975?

How does the registered representative fit into your firm's overall marketing strategy? Has he been the focus of that strategy in the past and will he be in the future?

Do your clients value the investment advice they receive from the registered representative? What is the exact nature of the broker/client relationship and should it be changed in the future?

Should the firm create different levels of registered personnel to serve different investors' needs? What services should registered representatives provide to clients in light of the anticipated changes due to possible unbundling?

Does the firm now have a reasonably accurate idea of its average transaction cost, marginal cost, etc.? Does the firm know the costs of supplying services such as research, custody, etc., to clients?

Does your firm have a systematic program for evaluating the cost implications of marketing and sales decisions?

How will stock market fluctuations in volume or price affect the firm's costs for providing various services to investors?

Can the firm's present accounting system classify expenses in a meaningful way? Are new systems being developed that will be flexible enough to generate accurate data for pricing decision-making?

Has the firm determined the criteria to be used in its pricing strategies and how these strategies will fit into the firm's overall marketing programs?

Is the firm developing a system to monitor its pricing decisions? Who will direct the firm's monitoring system to determine the firm's pricing problems?

Has an individual or a group of individuals in the firm been assigned the responsibility for making ultimate decisions on price flexibility?

Should the firm charge separate fees for services such as opening an account, account maintenance, or transferring an account into or out of the firm, etc.?

Should the firm offer some of its services as loss leaders to stimulate demand for other financial services offered to clients?

Should the firm base its revenues on commissions, or will it be more advantageous to charge annual fees for the services offered to clients?

Do other pricing concepts—such as percentage increases or decreases from present fixed schedule, round-trip discounts, and posted prices with flexibility for allowing volume discounts—have a place in the firm's marketing thinking?

What methods does the firm intend to use to gauge customer reactions to changes in pricing policies?

How will management determine the consequences of price changes and marketing programs on the firm's profitability?

Will management be able to isolate those product areas and price strategies that have substantially contributed to increased or decreased profitability?

Will the firm's prices reflect negatively on its image and on the services it provides to existing and potential clients? Is a discount operation right for the firm?

In offering services, should the firm concentrate on quality differences or price differences, or both, depending on clients and/or geographic markets?

Will existing and potential clients be confused by too many price choices for the firm's services?

Will the firm's price policy attract customer types in the short run which will adversely affect the firm's profitability in the long run?

Will the firm's pricing policies make investors unduly price sensitive and unappreciative of quality differences?