THE NEED FOR FIXED FLOOR BROKERAGE RATES

A Report Submitted to the Securities and Exchange Commission

New York Stock Exchange, Inc. May 29, 1974

INTRODUCTION AND SUMMARY

The New York Stock Exchange has, many times before this Commission, presented its views on the benefits of maintaining a strong and viable auction market mechanism. The auction process allows a better chance for the various buying and selling interests to interact and adjust the fundamental supply/demand factors more quickly. The ability to execute trades in the auction "crowd" within the specialist's spread, without any dealer participation or intervention, makes such a market inherently more efficient in terms of cost to the public.

Because of the accuracy and visibility of auction market evaluation, stock prices have come to serve an indispensable, multi-faceted function within our capitalistic economic framework. They help determine the level and distribution of asset holdings throughout the economy. They both reflect and influence public confidence in the economy and, therefore, exert a powerful impact on the willingness of corporations to invest and of consumers to buy. They help determine the ability of new and growing companies to raise capital, and of seasoned companies to innovate and expand.

Yet this value of the auction market to the economy would be meaningless if such a system worked only in good times, but broke down during periods of crisis, when its need would be most keenly felt. In this regard, the exchange auction market system has proved its true value. Throughout periods of boom and bust, throughout the series of operational and financial crises which rocked the securities industry a few years ago, the auction markets continued to function smoothly.

Millions of orders to buy and sell listed securities poured into the market. Bids to buy and offers to sell continued to meet in a two-way auction to produce the best available price for both the buyer and the seller at a given moment. The forces of supply and demand, constantly interacting in the auction crowds of brokers on the stock exchange trading floors, continued to evaluate and determine the prices -- sometimes rising, sometimes falling, sometimes remaining unchanged -- of the stocks of the world's major corporate enterprises, and continued to keep those price changes orderly.

The New York Stock Exchange firmly believes that the internal structure of the auction market, developed over many decades, is largely responsible for the ability of that market to serve the public and the economy so successfully. Specialists, independent floor brokers, and public firms all interact on the floor of the exchange, maintaining a system whose efficiency is acknowledged throughout the world. And one of the important ingredients which strengthens and enables this process to work by providing the guidelines for those interactions, is the system of fixed minimum floor brokerage rates.

Elimination of fixed minimum floor brokerage rates would compromise the public interest by creating major problems for specialists seeking to fulfill their responsibilities for maintaining markets in their assigned issues. This could weaken the securities industry at precisely a time when its ability to serve investors, and to supply and allocate tremendous amounts of capital needed to assure national economic progress, will be most critical. Furthermore, in the critical period ahead, during experiments aimed at developing a national securities market system, maintaining incentives to market-making may be especially vital to assure the continued viability of the Exchange auction mechanism during the transition phase.

In re-examining the merits of fixed floor brokerage, two key factors must be kept in sharp focus. First, since April 1, 1974, public commission rates charged by NYSE member firms on transactions of $2000 and less have been competitively determined. Second, the Commission has scheduled a changeover to fully competitive rates on all transactions to become effective on May 1, 1975.

The Commission evidently is concerned that these major structural changes in pricing member firm services could have a dramatic impact on the operational efficiency of the market and, therefore, on the investing public. Implicit in the Commission's approach to its examination of floor brokerage rates is the question of whether a concurrent major change in the existing rate structure will adversely affect the market and those who depend upon its market-making and execution capabilities.

Specifically, the SEC, in Release No. 10751 of April 23, 1974, has requested a hearing "to gather comments, views, and data concerning whether the initiation in the near future of a limited experiment in competitive intra-member rates of commission on orders not exceeding $2,000 would cause substantial and irreparable harm to floor brokers or to the market-making function of specialists, and whether it is necessary or appropriate in the public interest for the protection of investors for exchanges to maintain any prescribed schedules of intra-member rates of commission."

The New York Stock Exchange believes that any discussion of a limited experiment in competitive intra-member floor brokerage rates must focus on the general issues of competitive floor brokerage vs. fixed floor brokerage, rather than on the specifics of a limited experiment. The Exchange is convinced that many problems of competitive floor brokerage -- for example, the ability to maintain peak execution capacity on the trading floor, and the maintenance of fair and orderly markets -- would not be apparent in an experiment involving only orders under $2,000.

Therefore, this report examines the various philosophic and economic issues associated with the concepts of fixed and competitive floor brokerage rates _per se_. This examination makes it clear that retention of fixed minimum floor brokerage rates is in the best interests of the investing public and the securities industry itself.

The Exchange believes that competitive floor brokerage would drastically change the character of the trading process, accentuating the characteristics of a dealer market and weakening the public benefits derived from auction market trading -- to the obvious, and possibly severe, detriment of the investing public and the economy as a whole.

Accordingly, the NYSE Board of Directors strongly recommends against any action at this time which would alter the current structure of floor brokerage charges.

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This report is divided into two sections. The first presents the basic rationale for retaining the present system of minimum floor brokerage rates and demonstrates that these rates result neither in excessive costs to the public nor in excessive profits for members. The second section focuses on how competitive floor brokerage rates could adversely affect the securities industry's ability to serve the investing public, by impairing market-making effectiveness, by creating problems in working relationships on the trading floor, and by generating serious operational difficulties.

I. FIXED MINIMUM FLOOR BROKERAGE RATES: A SYSTEM WHICH WORKS

Fixed minimum floor brokerage rates are crucial to the exercise of the specialists' obligation to maintain continuous, fair, and orderly markets in the stocks assigned to them. Therefore, an understanding of how the specialist system functions is essential for a proper appreciation of how fixed minimum floor brokerage serves the public interest in the maintenance of an efficient, high quality Exchange auction market.

The specialist facilitates the operation of the market in two ways. First, he holds, as agent, orders that are away from the market for execution when the market price reaches the order price. By holding and executing these limit orders on behalf of other Exchange members, the specialist frees those members to transact orders elsewhere on the Floor, while assuring them and, more importantly, their customers that limit orders will be executed at the earliest opportunity. In this capacity as the investor's agent or as a broker's broker, the specialist receives floor brokerage fees.

Second, and more complex, is the specialist's dealer function. In that role, the specialist is charged with alleviating the temporary disparities between supply and demand by buying or selling for his own account. In doing so he imparts liquidity to the market while maintaining price continuity. This permits the public customer to receive prompt execution, and at a price reasonably related to the last sale price at the time the order was placed. The narrowing of price uncertainty improves the public's willingness to trade. In turn, the greater the number of orders, or market depth, the better the likelihood of maintaining price continuity and market quality. Thus, by creating an environment that minimizes short-term trading uncertainties, the specialist as a regulated dealer plays the pivotal role in maintaining and enhancing the quality of the Exchange market.

However, the specialist is exposed to high risks by his affirmative obligation to keep spreads narrow, restrictions on his ability to withdraw from market-making when ordinary business judgment might demand it, and other restraints imposed by his duty to maintain fair and continuous markets. The flow of floor brokerage income is his major incentive for taking these risks.

While the specialist is often considered the key man in the auction marketplace, other individuals on the floor also play important roles in the functioning of the system. Among these are the independent brokers, also known as $2 brokers. They execute orders, as agents, for other members who may be absent from the floor or who may be extremely busy. They also execute orders for member firms who prefer to utilize the services of their own members in other phases of the securities business, rather than on the Exchange floor. For these services, the independent floor brokers collect floor brokerage fees from the member firms whose business they handle.

Another important group is the commission house brokers who are members employed by firms doing a public business. They execute the orders which their firms send to them on the floor, and are compensated directly by their firms. However, when the flow of orders from their employers are not sufficient to keep them busy, some of these brokers will handle orders for other firms, collecting floor brokerage fees for their employers in the process.

Floor brokerage, then, is one important source of revenue for many members of the Exchange. And one of the most valuable qualities of fixed floor brokerage is its ability to contribute to a stable revenue flow.

In this context, minimum floor brokerage rates are an essential element of a functioning auction market and, therefore, are beneficial to the various sectors of the economy served by the auction market. Two basic propositions support this assertion: first, fixed rates provide an important economic incentive for specialists to accept the risks associated with his unique market-making responsibilities; and second, fixed rates help to maintain a vital peak-load capacity for the system by inducing both independent brokers and commission house brokers to remain active during periods of slack volume. In addition, it should be noted that fixed rates have no significant impact on charges paid by the public.

ECONOMIC EFFECTS OF MINIMUM FLOOR BROKERAGE

In its policy statement on the structure of a central market system, the SEC noted that such a system "can maximize the opportunity for public orders to match each other and be executed in classic auction market fashion."[1/] Thus the Commission recognized the importance of preserving the auction mechanism and self-regulatory framework of the exchange system. Therefore, the effect on the operation of that mechanism resulting from any proposed change in the structure of the auction market system becomes a key issue in the evaluation of that proposal.

The current structure of fixed floor brokerage rates affects the activities of specialists, floor brokers, and public firms in such a manner as to enhance the functioning of the auction market process. As the economic rationale underlying these effects differs somewhat for these groups, it is necessary to examine each individually.

Specialists. Floor brokerage income is highly significant to the specialist. During 1973, 40 of the 67 specialist units suffered dealer losses. Twenty-eight of those units, however, accrued sufficient floor brokerage income to offset their losses while 12 units did not. Thus, floor brokerage was the crucial income factor, spelling the difference between profits and losses, for over 40% of the specialist units in that year.

1/ Policy Statement of the Securities and Exchange Commission on the Structure of a Central Market System, March 29, 1973, p. 7.

Thus it can be seen that specialist floor brokerage income, by providing a relatively stable and continuous source of revenue, made it economically worthwhile for them to perform market-making activities and accept associated responsibilities which might not have been feasible if their total revenues had been more dependent upon trading account income. Put another way, minimum floor brokerage provides a revenue inducement for specialists to accept the regulatory responsibilities of being an NYSE specialist.

The importance of this fact is often overlooked. The securities industry is one of the few regulated industries in which an individual can choose the level of regulatory responsibility he is willing to accept. The NYSE specialist, as the most stringently regulated individual in the industry, must have valid reasons to accept the heaviest regulatory burden imposed upon him.

Fixed minimum floor brokerage provides this economic incentive to the specialist by supplying him with a relatively stable income source, thereby reducing his risk exposure. Moreover, minimum floor brokerage is desirable from both economic and public policy viewpoints, as the public receives significant benefits for a relatively small cost.

The income stability provided by fixed minimum floor brokerage allows specialists to assume market-making risks in unstable markets (part of their regulatory responsibility) which would not otherwise be economically feasible. If a continuous flow of floor brokerage income could not be relied upon during these periods, an NYSE specialist's ability to deal would suffer. However, his responsibility to maintain fair, orderly, and continuous markets in his assigned issues would require him to take positions which he would prefer to avoid, and which might well result in substantial trading losses to him.

Floor brokerage income would still continue for the NYSE specialist even without a fixed rate schedule. However, it is probable that the level of revenues produced would be lower when capacity on the floor is not fully utilized. In such an event, the risk associated with his market-making responsibilities as a specialist would rise above its present level.

Since most specialists would prefer to remain in their current roles, the natural tendency would be for them to attempt to compensate for the additional risk. This would result in a widening of their dealer spreads, the effects of which are detailed in Section II of this paper. While some specialists will successfully achieve their goal of compensating dealer revenues, others might not, and natural economic forces dictate that some specialists would be forced, by economic necessity, to relinquish their specialist roles.

Thus, despite the strongest intentions of specialists to continue their operations, in the long run there would be fewer specialists operating on the floor of the Exchange. In general, the lower the level of floor brokerage reached after the introduction of competitive intra-member rates, the more pronounced would be the loss of specialists to these other activities.

An auction market system is generally considered preferable from the point of view of the individual investor. However, it has been widely acknowledged throughout the securities industry that reduced public participation has been an unfortunate development from a public policy standpoint, and a key factor in the current financial plight of the industry. It therefore stands to reason that any loss of specialists to alternative activities would tend to push the securities industry in precisely the direction in which it should not go -- towards further fragmentation of the auction market at the expense of its ability to serve the general public.

The retention of a fixed floor brokerage schedule as an incentive to specialist market-making, then, can be shown to be of positive benefit to the general public, as it provides an economic inducement for specialists to continue to accept the additional costs and risks associated with the maintenance of fair and orderly markets. Continued public participation in the securities markets is generally considered a major public policy goal, and retention of fixed floor brokerage is in harmony with that goal.

<u>Independent Floor Brokers</u>. Most floor brokerage by non-specialists is done by brokers for firms rather than by independent floor brokers. In 1973, for example, 196 indpendent floor brokers received less than

$8 million in brokerage fees, of a total $33 million received by all non-specialists. Unlike floor brokers associated with commission houses, however, most of the independent brokers depend entirely upon floor brokerage revenues for their income. Thus, floor brokerage rates are of primary consideration to them.

For this group, fixed minimum floor brokerage rates almost certainly produce a higher level of floor brokerage income in slack volume periods than would competitive rates. This induces many floor brokers to remain active in anticipation of future opportunities. However, the need for a large number of independent floor brokers has sometimes been questioned. The relevant issue, then, is whether or not the retention of floor capacity at a higher level than could be expected under competitive floor brokerage rates results in a benefit to the public.

Although the independent floor broker performs many useful functions on the exchange floor, the primary advantage to the public of a relatively large number of independent floor brokers is the preservation of peak-load capacity. During periods of heavy trading volume, the independent floor brokers execute orders for other members who may be too busy to remain at a particular trading post attempting to effect a transaction. Although precise figures are not available, most floor brokers agree that the bulk of their revenues are generated on a relatively small number of days when trading is particularly active.

The peak-load problem on the New York Stock Exchange is often underestimated, in part because reported annual or monthly averages tend to obscure wide variations in daily or weekly volume. For example, NYSE average daily volume in 1973 was 16.1 million shares. However, on a monthly basis, average daily volume in 1973 ranged from 11.8 million shares in August to 19.8 million shares in December. And on a daily basis, volume ranged from a low of 9 million shares to a high of over 26 million shares. Similar variations have occurred in other recent years. Thus, any attempt to determine an "appropriate" or "necessary" corps of floor brokers based on annual, or even monthly volume averages overlooks the problem of serious shortages of floor brokerage capacity on active days when service is most necessary. Even on days having "ordinary" volume levels trading activity may become so high during some hours that peak-load capacity becomes important.

A critical problem associated with changes in the number of active floor brokers is that declines tend to be irreversible. This occurs as a result of the fact that only a limited number of individuals are qualified for these positions at any particular time. As departing brokers commit themselves to other endeavors, the replacement rate at peak demand periods will fall below the departure rate in inactive periods. Thus, if declining floor brokerage rates due to competitive pressures when volume was low thinned the ranks of independent floor brokers, the loss in capacity would probably never be fully made up, even at a later date when higher volume levels might stimulate higher rates. This "ratchet" effect could have serious consequences in terms of the floor's ability to handle the large swings in volume which now occur and can be expected to continue as the absolute level of volume tends to rise over time.[2/]

Public Firms. Fixed minimum intra-member rates offer an incentive to public firms to have a broker on the floor in order to avoid paying the fixed rates, and only a member firm may have a broker on the floor. The extensive use of "house brokers" by public firms is evidence of the importance of this concept. Here, too, the public benefits from the resulting maintenance of peak-load capacity.

In addition to avoiding the payment of floor brokerage to others, having a broker on the floor makes it possible to collect such brokerage as well. Many small firms simply do not have a sufficient flow of orders to justify the cost of their floor broker's continued presence on the Exchange floor. However, when he is not executing orders for his firm, a house broker can earn income for the firm by executing orders for others and collecting floor brokerage. In 1973, for example, commission house brokers generated $17 million for their firms. Thus, the higher level of income provided by minimum rates makes it economically feasible for

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2/ A strong relationship exists between magnitude of short-term volume fluctuations and the absolute level of trading volume. For example, see "A Model for Short-Term Volume Forecasts", Perspectives on Planning No. 11, New York Stock Exchange, December 1972.

many small firms to retain a man on the floor.

Fixed minimum floor brokerage rates are important to small public firms for another reason. With competitive rates, large commission houses would obtain quantity discounts as a matter of course. The quantity discount is common in the business world, and is rarely considered "discriminatory" in the negative sense of the word. However, in floor brokerage, the widespread use of quantity discounts by larger firms would hurt smaller firms, especially those attempting to handle occasional large orders. Fixed floor brokerage, however, by preventing rate competition among floor brokers, effectively precludes such situations and maintains the incentive for smaller firms to compete for those orders.

COST TO THE PUBLIC

In examining the system of fixed minimum floor brokerage rates, it is necessary to inquire into how those rates affect the cost of brokerage to the general public. In general, several criteria may be used to evaluate the reasonableness of rates including the reasonableness of profitability levels for recipients, and the avoidance of excessive charges to the public.

Reasonableness of Profitability Levels for Specialists and Floor Brokers. The term "reasonable" is both qualitative and relative in nature. In the absence of detailed data on risk and return in various alternative occupations, it is not possible to judge absolutely what constitutes a reasonable return for specialist and/or floor brokerage activities. In general, however, the specialist function is usually considered a high-risk activity, and as such is expected to achieve a higher rate of return on capital than might be found in many business endeavors. Whether this higher return is "excessive" depends on qualitative judgments of the value of the services performed.

While the risk of the floor broker is generally considered to be lower than that of the specialist, it is almost certainly higher than for most businesses. To be sure, relatively little capital is exposed, and there are no trading risks incurred as a result of market-making obligations. However, the floor broker is subject to a number of risks when acting in his agency capacity. Such risks can generally be classified in three areas: 1) errors, 2) uncertainty of order flow, and 3) missing the market.

Like the commission house broker, the $2 broker can make an error on a transaction if he misunderstands the often-complicated terms of the order he is representing. This could involve the size of the order, a price limit stipulated by his customer, or the conditions under which the order should be cancelled. Unlike the commission house broker, however, the $2 broker will generally have to personally absorb any error-based loss in his error account. (As a rule, a commission house broker's error will be taken into his firm's error account and not charged to him personally.)

The \$2 broker must rely on member firms to entrust orders to him on a strictly agency basis for his livelihood and must appropriately service the member brokers. Since he has no contracts with the firms on which he depends for his business, the \$2 broker does not know from one day to the next how much business he will receive, if any, or whether a particular firm will continue to require his services.

Finally, a potential hazard for the \$2 broker is that of "missing the market." This may occur not only when the \$2 broker handles a number of orders at the same time, but also in handling specialized orders, such as those involving arbitrage or large institutional orders, where discretion is involved. Since the \$2 broker cannot physically be in more than one location at the same time, it raises the risk of his "missing the market" on behalf of a client's order and thus, subjects him to the possibility of having to make good on these missed transactions.

When handling arbitrage orders, the \$2 broker must keep his client member firm continually aware of the quotations and size in both the convertible issue and the common issue in order to ensure the ability to identify profitable arbitrage opportunities. Failure to do so could also result in "missing the market" and either a monetary loss or a loss of subsequent business to the \$2 broker.

Impact on Public Rates. For all practical purposes, floor brokerage has little effect on the public commission rate. The percentage of the public rate represented by floor brokerage is currently about 7%-8% for most orders, ranging between 6% and 13% depending on the size and dollar value of the order. More importantly, this percentage has been steadily declining over time, as recent public rate adjustments have not been accompanied by parallel adjustments in floor brokerage rates.

Floor brokerage costs, as noted above, represent a very small fraction of the total commission charged. Therefore, it is unlikely that fluctuations in the floor brokerage rate could have much effect on the public rate. Even if average floor brokerage rates were to fall by as much as 40% from competitive pressures, the maximum effect on public rates (assuming that all cost savings were fully passed to the customer) would be 40% x 8%, or in the neighborhood of 3%. Since public commissions currently average about 1% of the dollar value of orders below $300,000 (2 % for orders under $2,000), the maximum cost to the public of maintaining minimum intra-member rates is somewhere between 3/100 and 6/100 of 1% of the total value of the order placed.

In the opinion of the Exchange, a cost of less than 5¢ per $100 invested is not only utterly lacking in excessiveness, but is in fact a bargain, compared with the public benefits provided by the activities which that cost supports. If, indeed, the very survival of the specialist system is dependent upon the continued existence of this extra .05%, then the value received by the public would be worth many times the cost.

II. COMPETITIVE FLOOR BROKERAGE RATES: SOME POTENTIAL PROBLEMS.

The preceding section presented arguments specifically supporting continuation of the current floor brokerage rate structure. The alternative -- competitive floor brokerage -- is examined in this section.

The New York Stock Exchange believes competitive floor brokerage would pose serious problems in three major areas. First, competitive rates would impede the ability of specialists to make markets in their assigned issues; second, they would adversely affect the working relationships among specialists, floor brokers and public member firms, as well as among the floor brokers themselves; and third, they would create costly operational difficulties, especially with regard to pricing and billing.

IMPAIRMENT OF MARKET-MAKING ABILITY

While fixed minimum floor brokerage rates provide, as discussed previously, a strong incentive to market-making, the specialist function would of course continue under a competitive rate system. However, the character of that operation would probably undergo drastic changes. Through increased competition with floor brokers, specialists would find their floor brokerage income reduced. This would have a considerable impact on their ability to make markets in their assigned issues.

Specialists currently accept responsibility for maintaining fair and orderly markets in high-risk inactive stocks (which require extensive dealer participation) partly because losses sustained in them may be offset by brokerage income stemming from their more active issues. If this income were reduced, specialists would be less able to engage in costly market maintenance of the less active issues.

The reduction in the ability to deal in secondary securities would develop gradually. However, as that ability declined, a perceptible loss of liquidity characterized by wider spreads and greater price disparity between sales, would become evident. The widening of spreads would probably affect public trading patterns in two ways: first, there would be a shift from market to limit orders; and second, there would be a general decline in activity in these issues, further exacerbating the problems of issues whose securities are traded in the so-called "second tier." In a sense, it would create dealer markets in these issues, rather than auction markets.

Such a change would be a severe detriment to the investing public and the economy as a whole, as the recent experiences of the over-the-counter (OTC) market poignantly bear witness. In times of declining share prices, dealer trading markets often dry up competely. According to a recent survey of over 2,716 OTC stocks, 718 had no market-makers quoting their shares.

According to Arthur H. Rogoff, vice-president of Robert S. Taplinger Associates, Inc., who conducted the survey, the problems created by such a situation go far deeper than the losses that investors suffer. The companies themselves are hurt, since it becomes difficult to obtain funds for expansion. When a small company seeks a loan, the bank often asks the officers to co-sign. Often, the bulk of these officers' assets are represented by stock in the company. If there is no market, however, there is no collateral for the loan. Thus, the problems which competitive floor brokerage could create might indeed be far-reaching if such changes in the character of the market came to pass.

Competitive rates could bring about other undesirable effects. Under competitive rates, a specialist must have the right to refuse to accept an agency order when he regards the commission offered as unacceptable -- just as the commission broker today can refrain from giving an order to a specialist if he feels the current floor brokerage rate is too high, choosing instead to hold the order himself for execution. However, the specialist's right to refuse to accept agency orders could be detrimental to the efficient operation of the auction market. So-called "love" orders at the opening,[3/]

3/ "Love" orders are marketable orders given to the specialist prior to the opening of the Exchange to facilitate stock openings. No floor brokerage is charged for their execution.

on which no brokerage is currently charged, offer a case in point. Also, the right of rejection could place undue hardships on some brokers and, ultimately, create dissatisfaction among customers.

Reduced income levels from floor brokerage would, of course, adversely affect specialists' profit potential and have the peripheral effect of making it more difficult to attract outside investment. With the securities industry facing critical capital shortages, any additional disincentives to potential investors may have serious long-run consequences.

EFFECTS ON WORKING RELATIONSHIPS

Working relationships on the floor of the Exchange would undoubtedly deteriorate in an environment of competitive floor brokerage. Conflicts would arise in relationships between specialists and floor brokers; among floor brokers themselves; and between both groups and the member firms they serve. Initially, the investing public would suffer most from these problems, but the securities industry itself would be the ultimate victim.

Between Specialists and Member Firms. Depending upon the manner in which the specialist negotiates his rates with member firms, some problems could arise. If specialists were to negotiate separate rates with the various firms they service (instead of posting a single price to all comers), there could be a very real possibility of discrimination. Firms paying higher rates would expect better service and prices on executions of their orders, e.g., a single price on small orders, as opposed to multiple prices.

Between Specialists and Floor Brokers. Specialists and floor brokers currently compete with one another on a service basis. Under competitive floor brokerage, however, floor brokers would be able to engage in direct price competition with specialists as well. As noted earlier, however, the floor broker's risks -- chiefly reflecting an uncertain order flow and a responsibility to his client when an order he is representing "misses the market" -- are generally less than those of the specialist. The difference in risk between the two groups should make it possible for the floor broker to undercut the specialist and successfully compete for orders in active issues.

A floor broker wishing to engage in such competition would position himself at a particular trading post where stocks in which he wanted to deal were traded. He would then offer his services on all orders in those issues at a charge lower than the specialist's. This would seriously reduce the income of the specialist, who, -- it is essential to recognize -- relies on his high-volume stocks to provide the bulk of his income. The transfer of specialist income to the floor broker would impair the specialist's ability to maintain liquid markets in his less active issues.

It has been suggested that some specialists, responding to competition, might exert pressure on their larger customers and refuse to handle large, difficult orders from firms that used a less costly floor broker to handle smaller orders. Such action would, in effect, be a form of service competition by the specialist, who would be well within his rights under his present market-making obligations. However, the animosity likely to be provoked by such action would severely strain the essential working relationships among all three groups -- specialists, floor brokers, and member firms -- and undoubtedly work to the detriment of the entire system.

Among Floor Brokers. Floor brokers currently compete with one another only with regard to service. In general, those brokers who consistently provide the best executions for member firms will tend to receive the bulk of those firms' orders. However, under competitive floor brokerage, price competition would also become a factor.

Price competition among floor brokers could lead to rate discrimination, with quantity discounts given as a matter of course to large commission houses offering the most business. This would hurt smaller firms, especially those attempting to handle occassional large orders. Thus competitive rates might actually lead to reduced competition among large and small firms for the larger orders.

Similarly, competition among floor brokers could conceivably be reduced by elimination of minimum floor brokerage rates. Commission houses seeking quantity discounts would tend to concentrate their business with a single broker wherever possible. An initial surge of competition might immediately follow the changeover to competitive rates, but following establishment of a new equilibrium, a marked increase in concentration of business would be likely, to the advantage of a relatively small group of floor brokers.

OPERATIONAL DIFFICULTIES

Competitive floor brokerage implies the possibility of a multiplicity of rates. It is feasible that different rates could be charged for different types of orders, e.g., market orders vs. limit orders; for different stocks assigned to the specialist, e.g., high-risk vs. low-risk issues; and possibly even for different customers, e.g., volume discounts or even fixed annual retainers for high-volume customers. If such pricing policies were to prevail, billing operations would become much more complicated for many firms.

Two major operational problems might result from fully negotiated floor brokerage rates. First, each execution report might have to show the brokerage rate for that particular transaction. This information would then have to be recorded by the firm placing the order, creating additional paperwork and increasing the possibility of errors. Second, end-of-month billing reconciliation with specialists and $2 brokers could become a serious problem. In

CONCLUSION

Fixed minimum floor brokerage rates play a major role in perpetuating the smooth functioning of the auction market process. At an insignificant cost to the public, minimum floor brokerage helps assure a sufficient floor capacity over the course of the business cycle, and the maintenance of continuity, depth, and liquidity by specialists in their assigned issues during bull and bear markets alike. By smoothing out income flows in one of the most cyclical industries in the economy, fixed minimum floor brokerage serves the public interest by guaranteeing that the auction market will be there whenever it is needed.

Competitive floor brokerage, on the other hand, would be a destabilizing force on the industry. During non-peak volume periods, competition for business would tend to drive rates downward, creating economic conditions detrimental to the long-run health of the industry. During peak volume periods, rates would tend to rise as a result of strains on capacity caused by a loss of floor brokers caught in earlier cost squeezes. The net effect would be an industry in constant turmoil, ill-equipped to handle the cyclical needs of the investing public and the capital-raising sectors of the economy. In the long run, neither the securities industry nor the public interest would be served.

The efficiency of the U.S. exchange auction market process is acknowledged throughout the world. Its liquidity, depth, and order to reconcile the monthly statements, <u>every</u> order executed during the month might have to be checked since each order could involve a different floor brokerage rate.

The possibility of operational difficulties would not, in itself, argue persuasively against a shift to competitive floor brokerage. However, an important assumption underlying the evaluation of the present and proposed systems is that floor brokerage rates would tend to be lower in a competitive environment, and that some of these savings might be passed to the retail customer in the form of reduced commissions. Clearly, operational difficulties could raise back office costs sufficiently to offset any expected floor brokerage savings. And this would negate a major alleged benefit of competitive floor brokerage rates.

continuity are unrivalled. And the underlying source of this strength is the stability of the system itself -- the ability of the marketplace to function in an orderly manner whether daily trading volume is ten, twenty, or thirty million shares. Preservation of the current structure of floor brokerage rates is vital to the maintenance of this stability, which insures the ability of the marketplace to serve the full needs of the investing public and the national economy.