SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
(202) 755-4846

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COMMISSION RATES - - THE WORLD AHEAD

An Address By

Ray Garrett, Jr., Chairman

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Yesterday, Commissioner Sommer spoke of the securities industrial revolution, of its hardships and also of its necessity to adjust to changing economic - - and, one might add, social and political and technological - - reality. I suppose revolution is not too strong a word, properly understood. But it was not intended to carry with it some of the connotations frequently associated with that word. It is, in our case, certainly not an uprising, nor is it conceived, by the government at least, as massive punishment.

Too much of this process of restructuring has been accompanied by accusatory language, and many of us have contributed to creating an atmosphere of blame and hostility. In the total movement toward a central market system, there is certain to be disagreement along the way. All persons presently engaged in the securities industry are not going to share in the benefits of change to an equal degree. Many feel threatened at the prospect of change, any change, especially at a time when the financial condition of the industry is at such a low ebb. Some are sincerely convinced that the whole central market movement, and especially the unfixing of commission rates, are wrong. Some believe that, to the extent that there is any good in these new ideas, they should be put into effect only by the voluntary action of industry itself and not imposed by Congress, still less by the bureaucracy.

I understand these differences of opinion, particularly in these hard times, and I respect them. Because I know that so many persons in the industry disagree with the concept of price competition in the brokerage business and dread the consequences of its coming, I want you also to know that I respect the diligence with which the industry generally is preparing itself to operate in the new environment.

The securities industry is often accused of excessive greed and short-sightedness. The worst criticisms of this nature that I hear, incidentally, come privately from your own ranks in moments of extreme exasperation. I hope that when the history of this period is written, full credit will be accorded to those many members who are working diligently for necessary and beneficial change and who are planning intelligently for the new world. I know such planning is not easy, especially for smaller firms that cannot afford a full-time staff for the purpose, and for many of you it is distasteful. I, therefore, applaud your efforts, including your attendance at seminars such as this.

A funny thing happened on the way to competitive rates. About ten days ago a member of our staff reported, with a twinkle in his eye, that he had heard a rumor that the industry was about to file a proposal to increase minimum commission rates because of cost increases incurred since last summer's proposal. He suggested that the Commission should be prepared not only to have public hearings as soon as possible on the matter, but to expedite evaluation of the record. On the basis of past experience, that would have meant that the hearings would have begun sometime in July; the time for submitting comments for the record would have expired sometime in August; and by mid- or late-September the Commission would be prepared to announce its conclusions with respect to a rate increase. If all went well, a rate increase in response to increased costs might have been implemented as early as October 1.

When the story proved unfounded, we had to save the rumor monger from the clutches of staff members who have not had many summer vacations in the past six years because of their participation in commission rate hearings and the preparation of reports to the Commission on those hearings. Instead, the nation's largest retail brokerage firm

had the courage to announce last week that on July 1 it would increase commission charges an average of 5 percent on all transactions up to $300,000 because of an increase in its operating costs. While other retail firms have also indicated that they too intend to increase their rates in response to increased expenses and inflation, to date, the industry has shown the wisdom not to play follow the leader in slavish fashion but has shown independence of judgment and a willingness to experiment. This has been most commendable, and I hope it continues.

You may recall that some economists had speculated that a rate increase could not be effected on stock exchange transactions without increasing the minimum commission rate lest "destructive competition" take hold at a time when the brokerage industry was faced with high fixed costs, inelastic demand and excess capacity. If you assume that these conditions are present in the industry today, we might speculate - - as indeed some persons have - - that the largest firms would lower their rates or at least not be the proponents of raising them in response to increased costs.

Whether those or other proposed rate increases stick is a question that will be determined, of course, in the marketplace, as is true for other businesses under free price competition. But competition need not necessarily result in decreased revenues or unprofitable operations, as some, more skeptical, individuals apparently fear. Indeed, if some industry members think rates should rise in response to increased costs, they can respond swiftly, if the market will stand it. There will be no need to incur a regulatory lag of at least three or four months duration in addition to the time spent within the exchange community achieving consensus on a proposal and preparing a case.

Similarly, if a member firm determines that its profitability will be enhanced by lowering its rates in response to changing market conditions, it presently can do so on orders involving up to $2,000 or more than $300,000, without having to persuade a majority of the stock exchange membership and the Commission of the wisdom of its conclusions. In short, steps taken in the past year to unfix commission rates are giving this industry price flexibility as well as price competition. Among the managers of businesses that are subject to rate regulation, a complaint most often heard is their inability to respond quickly and adequately to changing costs and other conditions. If you accept the proposition that you could not indefinitely have it both ways, you should give proper weight to the advantages of freedom.

You who participate at meetings, such as this one held under the sponsorship of the New York Stock Exchange, are examining questions which long have been with us but which have become apparent only with the announcement by the Commission last fall that we intend competitive rates to be applicable to orders of all sizes by May 1, 1975. Some of these questions involve the consequences of unbundling of services, the uses to which portfolio commission dollars may be put, and the need for fiduciaries who manage other people's money to understand what the consequences of competitive rates may be for them and their customers. In discussing these matters in an exploratory way, I should warn you that the Commission's customary disclaimer may be peculiarly applicable: The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for speeches by any of its Commissioners, including its Chairman. The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

It may be an oversimplification, but I doubt that the unfixing of rates is going to shift obligations or duties from what they have been up till now. Take, for example, the matter of suitability. If a customer tells his broker, “Don’t call me, I’ll call you and, when I do, I don’t want your advice or portfolio recommendations,” some industry members have suggested that the unfixing of commission rates, somehow or other, changes the broker’s obligations regarding suitability. In my view, however, the unfixing of rates will not alter existing obligations. Suitability was a concept that even predates the Maloney Act and was articulated many years ago in Section 2 of the NASD’s Rules of Fair Practice. That rule states:

> “In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his security holdings and as to his financial situation and needs.”

As you know, the NASD is, and always has been, prohibited by what is now Section 15A(b)(8) of the Securities Exchange Act from fixing commission rates or other charges for over-the-counter transactions. Its suitability rule has applied to solicited and recommended transactions effected by members for their customers. Conversely, it has generally not applied to unsolicited transactions effected by its members for customers who have wanted only execution of their orders, not advice or portfolio research. And I cannot believe that until now a stock exchange member organization has not had a suitability obligation to customers in unsolicited orders simply by virtue of the fact that the customer had to pay a rate which provided compensation for sales solicitation and portfolio recommendations which he did not receive or request. The broker’s suitability obligations to his customer arise from all the pertinent circumstances which relate to whether the transactions he effects for his customer were solicited or whether the

customers substantially relied on the advice or recommendation of the brokers, but the presence or absence of a fixed or minimum commission rate is not one of these.

Similarly, the unfixing of commission rates does not suggest to me that services which have appropriately been paid for until now by means of minimum commission rates may no longer be paid for under a regime of unfixed rates. We are all aware that the minimum commission rate has customarily provided for compensation for research. About 15 years ago, as institutional investment in common stocks began to become a noticeable factor in the competition for the public's savings, a number of bright, young men developed a new kind of in-depth research product geared particularly for institutional managers and their sophisticated analysts. It is an understatement to say that the concept caught on. It developed to the point where we are told by a considerable number of institutional mangers that they have come to recognize that no management company is capable of having, in-house, all of the best experts whose research and analytic services are useful for managing the highly diverse portfolios with which they are concerned. The largest managers of investment companies, trust departments and pension funds have sought out the opinions and reports of a limited number of experts who could not possibly work on an in-house basis for each portfolio manager who felt the need for supplementary research.

Minimum commission rates long have been used to pay for these services - - at first by means of give-up checks, and then, after give-ups were prohibited, by placing portfolio orders directly with the broker-dealer organizations who supplied this institutional research expertise and were able to develop satisfactory execution capability. Historically, payments for this supplemental research came out of minimum stock exchange commission rates because service competition has always been permitted under the "commission law" of stock exchanges. Service competition facilitated the development of research capability of a type that just two decades ago was virtually unknown. Parenthetically, I should note that it also facilited other well-known practices

that may have had less fortunate consequences for the markets, for the minimum commission rate system and for the clients of money managers.

Whatever utility this relatively new type of in-depth analysis has had in helping the market to price securities should in no way be diminished by the forthcoming change to competitive rates. Portfolio managers have been expending their clients' portfolio commissions in part for these services which presumably have been of benefit in making portfolio decisions for their clients. How could the continued expenditure of their clients' money for such services be of any less value to the clients under a competitive rate system? One might speculate that some portfolio managers paid for research which they viewed as of marginal utility, on the theory that no other supplemental services could be obtained for the minimum commissions being paid. However, most of the information that I get suggests that there have not been enough commission dollars to pay for all the supplemental research wanted.

The unfixing of commission rates does not require an unbundling of services. It permits it. As a result, portfolio managers will have a choice whether to pay for research by means of portfolio commission dollars ("soft dollars") or with money not designated as brokerage commissions ("hard dollars"). I might add that they will be able to pay hard dollars only if brokers who offer research are willing to accept payment for that service in the form of hard dollars. If such a broker insists upon being compensated by soft dollars in order to derive income both from his execution and his research profit centers, and if under all the circumstances he does not dominate a market for such research service so as to be in violation of the antitrust laws, the portfolio manager who believes that broker's supplemental research services are a benefit to his client may have no choice but to pay soft dollars if he wishes to obtain that research.

In all, I don't believe that the shift to competitive rates should make a substantial difference with respect to compensation for supplementary institutional research.

Persons whose money is managed, their lawyers, and state and federal regulators of money managers should realize:

first, that supplemental research for each industry represented in a client's portfolio cannot be obtained in-house by a money manager; and

second, that management fees have been established on the premise that supplemental research is paid for by the investor; if the institutional investor is to continue to receive the benefits of such services, it will have to continue to pay for them, either in the form of soft or hard dollars.

As a policy matter, it would be most unfortunate to require a money manager to pay for supplemental research out of his management fee. If, on the one hand, he were to receive a higher management fee in consideration of a newly-assumed responsibility to pay for supplemental research out of that fee, he would be subject to accusations that, because of a conflict of interest, he was not expending enough of his fee for such services. If, on the other hand, his fee were not increased, he could, with merit, conclude that supplemental research was not a service which he has been obliged to provide, since it certainly was not a factor included in determining his fee.

A final consideration respecting the effect of competitive commission rates on supplemental research relates to other potential conflicts of interest. Persons who assume fiduciary or agency responsibilities are always open to accusations of conflicts of interest. Broker-dealers, as that hyphenated word suggests, are confronted with potential conflicts of interest in a considerable number of their activities; over the years, they have developed means of establishing, if called upon to do so, that they have not taken unfair advantage of their customers in such situations. Similarly, portfolio managers who are confronted with fully competitive commission rates should be able to satisfy their clients, their regulators and the courts that they have not used the soft dollars or the hard dollars paid out of the funds they manage for their own benefit at the expense of the beneficiaries of the funds.

With adequate records, whether the supplemental research involved the transaction for which the soft dollars were paid or another transaction, or even involved a decision to forego portfolio activity, should be unimportant; what should matter is that the money manager be prepare to establish why soft or hard dollars are expended for the execution, research and other services provided to his client by the portfolio broker. I believe that such records will go far toward establishing the arm's-length bona fides of the payments and that anyone challenging their propriety would have the burden of establishing that the portfolio manager's decisions either were made for some ulterior purpose or that such payments were clearly outside the prevailing range of reasonableness.

A more difficult and more pervasive question arises with respect to situations where no especially fancy research is involved. In situations where the portfolio manager seeks only execution of the order must he, as a fiduciary, always seek the lowest obtainable commission? Obviously not where, for one reason or another, the execution is difficult. A portfolio manager who lost dollars on executions to save pennies on commissions would not be serving the best interests of his beneficiaries. Good execution is clearly more significant than commission rates when there is a meaningful difference in execution capability, and a portfolio manager who selects a broker for a transaction and pays his posted rate should not be held to account precisely for the dollar for dollar benefit, assuming the order requires something other than ordinary execution skills.

Perhaps the most difficult case is the easy order - - a market order of modest size for an actively traded stock, with no research to be compensated. In this situation, must the fiduciary always seek the lowest commission among the many firms that could presumably provide equally good execution? I understand that able counsel for some institutions, especially trust departments, are answering this in the affirmative. It is, without doubt, the cautious approach, the advice that would appear most likely to keep their clients out of trouble. And, of course, to a degree that is what price competition is

all about. Other things being equal, business should flow to the lowest price. Even where other things may not really be equal, the commission cost is exposed and measurable where countervailing intangibles may be hard to establish. Counsel is not being asked whether his client, the fiduciary, could win a lawsuit if brought, but rather how can his client avoid being sued.

It would be irresponsible of me in my present position to try to lure trust companies and others into possibly expensive mistakes by acting against the advice of their own counsel. I would, rather, urge counsel to bear in mind the totality of the considerations relevant to the selection of a broker by a portfolio manager. As long as you assume that the portfolio manager is not motivated by any improper considerations, it seems to me that, within a range of reasonableness, the judgment of the manager in this selection should have presumptive validity. We do not expect fiduciaries always to purchase the cheapest product or the cheapest service in other areas, and the value of such intangibles as quality of service, promptness of attention, many benefits from an ongoing relationship should be entitled to weight against marginal savings in commission costs.

On a broader scale, I think institutional investors are coming to realize the importance to them and their beneficiaries of a healthy, independent securities industry. While this does not justify throwing money away, it does, in my opinion, justify forebearance from the maximum use of economic power. This is true on a national scale, and I think it should be true locally. Surely brokers, like them, are entitled to reasonable compensation for their services.