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

"APPROACHING MAY DAY"

Address By

Lee A. Pickard
Director
Division of Market Regulation
Securities and Exchange Commission

The Bond Club of Buffalo
Buffalo, New York
March 20, 1975

It is a pleasure to travel to upstate New York and appear before you here at The Bond Club of Buffalo. The "upstate" label is one I share with you as I grew up about 150 miles east of here, outside of Syracuse.

I have been asked to talk about May Day, which to the uninformed, or I should say to those outside the securities business, means the international radio telephonic signal for help used by ships and aircrafts in distress. To some, however, it connotes distress over the fact that for the first time since 1792 when the fixed rates on securities commissions were established under the so-called "Buttonwood Tree Agreement," brokers will be required to be as competitive in their own business as the business they analyze for their clients. Then there are those who think of May Day as the international labor holiday celebrated with great enthusiasm by labor unions and by most of the Communist countries of the world, and they see special significance in the advent of unfixed rates falling on this holiday. In fact, I was recently informed that the SEC no longer stands for the Securities and Exchange Commission in the street but, rather, for the Soviet Economic Committee.

For those few who view the situation with such alarm let me assure you that the May 1 date was not decided upon for any of the foregoing reasons (at least not to my knowledge) and further, I think the distress for those few who may be experiencing it is misplaced.

By way of background, in January of this year the Commission adopted Rule 19b-3 under the Securities Exchange Act of 1934 which, in brief, prohibits on or after May 1, 1975, any exchange from adopting or retaining any rule requiring its members to charge fixed rates of commission for transactions effected on securities exchanges. It further provides that no member of an exchange shall be required to comply with any rule of an exchange attempting to fix commission rates after that date. However, as to floor brokerage commissions, the operative date for unfixing of such rates is deferred for one year until May 1, 1976. Thus, while public rates will become unfixed this May, floor brokerage rates, which are commissions applicable to the execution of transactions for members on exchanges, do not become subject to free competition until 1976.

At this juncture there is evidence that the exchanges intend to comply with this rule and thus, we can fully expect unfixed commission rates for public orders on May 1 of this year. It should be borne in mind, however, that brokers and dealers will not be newcomers to competition. Under the present rate structure, transactions on exchange orders up to $2,000 as well as orders in excess of $300,000 are subject to full competition as are, of course, other lines of businesses typically engaged in by securities firms.

In a general sense, the basic reason for the Commission's decision to adopt Rule 19b-3 was the conclusion that, under present circumstances, the free play of competition can provide a level and structure of commission rates which will better serve the interest of the investing public, the securities industry, the national economy, the public interest than any system of fixed prices which can reasonably be devised.

The decision represents a clear cut effort on the part of a regulatory agency to extricate itself from economic decision making and, in a sense, is consistent with the Commission's approach to regulation of other aspects of the securities industry, where it has relied upon free market forces to determine the system's structure and efficiency. The Commission, charged with the enforcement of the U.S. securities laws, has traditionally emphasized the process of full disclosure, and many commentators attribute the disclosure program, refined by the Commission over the past 40 years, as a principal contributor to the strength and vitality of our capital markets. Thus, at a time when Washington regulators are increasingly accused of protecting the industries they regulate, fostering anti-competitive practices and contributing to inflationary pressures, May Day represents the Commission's conscious effort to get out of the ratemaking business.

Let me not leave you with the impression, however, that the decision to unfix commission rates was one which was either made lightly by the Commission or with universal enthusiasm. The issue was debated long and hard within the Commission, and I would be disingenuous with you if I reported that the decision was arrived at with a clear idea of all of its ramifications. We believe we have chosen the proper course from the standpoint of the industry, as well as the public; or decision, however, was not based upon any simplistic notion that competition is a good thing in all lines of endeavor and that therefore competitive rates should be substituted regardless of experience and circumstances. The commission rate issue was given extensive consideration and study over the past twelve years not only by the Commission but by Congressional committees, the Department of Justice, the Treasury Department, exchanges, various firms and organizations in the securities industry, investors, and many independent economists and scholars. Voluminous material on this subject has been developed and considered since 1963 and the question of the unfixing of rates itself has been the subject of intensive hearings, before the Commission, for 3-1/2 years.

Having made the decision to unfix rates, we do not intend to remain aloof or insensitive to the consequences of that decision. To that end, the Commission announced last week a program to monitor the impact of unfixed commission rates. The program contemplates the filing, by certain broker-dealers, with the Commission, of revenue and expense and related financial information. Information will also be required to monitor changes in membership interests on securities exchanges. In addition, the program contemplates the study and analysis of a sampling of firms in order to develop information on commission rates being paid by individual and institutional customers and a review of the volume reports from securities exchanges and third market firms in order to determine the distribution of trading among the various market places. This program is being done in cooperation with the various exchanges and the NASD as well as the Commission's Advisory Committees. Every possible effort is being made to avoid additional reporting burdens upon the broker-dealer community.

In conjunction with this program we have proposed a rule which would require broker-dealers who are members of an exchange, who contemplate resigning that membership interest, to notify the Commission at least 45 days before the resignation. They would have to inform the Commission whether or not they intend to continue to effect transactions in securities traded on exchanges and, if so, what arrangements they have made to comply with our consolidated tape last sale data reporting system, and how they will effect transactions on such exchange for customers. In addition, a firm seeking to resign from an exchange would be required to send a notice informing all customers of its action and what effect the resignation will have on its ability to continue to service them.

Thus, we are seeking to determine, in advance, any significant disruption or alteration in the method of broker-dealers' doing business which could prove inimical to our capital markets. We hope to be able to insure, through this monitoring program, that investors are adequately served and that our capital markets continue to function in an orderly manner during this transitional phase.

We are asking all interested persons to comment on the monitoring program. To the extent you have suggestions or objections, we would appreciate hearing from you.

I think the proponents of fixed rates often overlook several critical factors in attempting to apply such a concept to the securities industry. Any system of fixed rates must be determined to be reasonable and that determination of reasonableness is generally the responsibility of a Federal, state or local governmental agency.

A determination of the reasonableness of a commission rate is an extraordinarily complex and subjective determination, and a determination which no doubt will become increasingly more complex in the years ahead. For most member firms, stock exchange transactions are a service business. Yet, does one base the rate upon a concept of reasonable return on capital? Should the return be different for debt capital than for equity capital? Going beyond that, there is the related, complex problem of trying to separate out expenses. A number of brokerage firms have repeatedly indicated that it is impracticable to allocate expenses so as to break down net income among such varied lines of businesses as securities commissions, underwriting and trading profits, since at any given time substantially the same sales personnel and branch office facilities are engaged in the generation of all these sources of revenue. As we all know, the latter categories of businesses are not subject to fixed rates nor should they be. Moreover, the New York Stock Exchange and other industry organizations have acknowledged that they have not established a basis for allocating costs between the stock exchange commission business and other business done by member firms.

It is also important to recognize that there are important differences between the securities business and the public utilities which are, in fact, subject to rate regulation. Public utilities normally possess a franchise conferring upon them monopoly rights to furnish services to the public. The franchise obligates them to furnish services to all who need it at reasonable prices. In contrast, the auction market of the New York Stock Exchange has about 500 member firms which actively compete with each other, and they also compete with other investment mediums for the public's savings. There are other important economic differences. Public utilities generally are characterized by relatively high investments in fixed plant and equipment while the securities commission business is essentially a service business requiring relatively small capital investment but relatively high personnel cost. These are merely some differences which make clear that the problem of a "reasonable" rate level cannot be solved by the simple transfer of principles evolved in the field of utility regulation to the securities commission business.

I submit to you that any attempt to restructure the securities industry to make it suitable for rate fixing would not only be an enormous task but, I believe, could result in a securities industry which is less dynamic and less appealing to those now in the business.

Many would view the substitution of the discipline of the market forces for Government regulation as justification in itself for the decision to eliminate fixed rates for brokerage transactions. But I would suggest that there are also other positive benefits flowing from the unfixing of commission rates. Through the elimination of the rigidity of the fixed rate schedule, brokerage firms will be free to experiment with different types of brokerage services for the public and will be more able to react quickly to changing business conditions. There undoubtedly will be closer scrutiny of the costs attendant to services provided by firms to their customers. Over the long term the unfixing of commission rates may well facilitate a trend away from compensation schedules based solely upon the amount of activity in an investor's account, with a greater emphasis upon management of that investor's account on a fixed fee basis. To the degree the industry is able to structure its charges upon the particular needs of individual clients and avoid the unconscious effort or the appearance of an effort to generate transactions in order to earn revenues, the securities industry would be on a more sound footing, avoiding its heavy reliance on volume fluctuations, and the public investor would seem to be better served.

Moreover, there is room for optimism in that the unfixing of commission rates will have positive effects upon the management of the securities industry as well. One of the principal findings of the Commission's 1971 Study of Unsafe and Unsound Practices of Brokers and Dealers, mandated by the Congress as a result of the paper crunch of the 1969-1970 period, was that the securities industry as a whole placed an undue emphasis upon sales promotion and that all too often it was individuals with strong sales records who rose to managerial and administrative positions in the brokerage firms lacking, perhaps, managerial ability or administrative experience. The unfixing of commission rates will compel management to seek more efficient ways of doing business. Obviously, sales are fundamental to the success of most businesses. So is competent management. The painful lesson experienced in the late 1960's, due to the absence in many firms of meaningful management systems and controls, highlighted this fact.

There is already evidence that the industry is deeply involved in the assessment of its cost base. Most visibly, the self-regulatory bodies, many exchanges and the NASD, are increasingly being asked to justify their existence, to produce tangible evidence as to their contribution. They are being asked to justify the approximately $180,000,000 of aggregate annual revenues they receive for operating the securities markets, overseeing the regulation of our markets and insuring efficient clearing and depository facilities. The $180,000,000 may be well spent, yet for the first time members of the securities industry are earnestly asking the self-regulatory bodies to justify their existence and functions. All this is a healthy sign.

The Commission recently completed its inquiry regarding bank-sponsored investment services, and the result of that inquiry is now being analyzed by my Division. The purpose of the inquiry was to obtain further information in light of current Congressional interest in the public policy implications of activities by banks in the securities field as well as to assist the Commission in determining whether present regulations governing bank equity security investment services are adequate. One of the more interesting pieces of information produced by that inquiry was that the New York Clearing House Banks provide, in the aggregate, dividend re-investment services for over 300 companies and have over 850,000 participating shareholder accounts. The First National Bank of Chicago reported in a survey of 100 of the largest American corporations that 39 had dividend re-investment plans and an aggregate of over 785,000 shareholders participated in such dividend re-investment plans. Dividend re-investment plans themselves are a form of brokerage service. The acceptability of bank brokerage services by the public is impressive when one considers a few years ago that such services were not available. It has been alleged that the success of banks offering dividend re-investment plans is in large measure attributable to the greater flexibility banks possess in pricing such services to the public. Dividend re-investment programs were first instituted by brokerage firms which subsequently found that the fixed commission rate structure inhibited their ability to compete for this business. The unfixing of commissions may well provide the means by which brokers will be able to combine their unique execution skills with flexible pricing strategies to become strong competitors for this type of business and similar types of services as well.

Finally, it would appear to me that the unfixing of commission rates will ultimately contribute to a more efficient capital market and a market which is less costly to its users. There is evidence that a combination of fixed minimum commission rates and barriers to access have tended to cause investors, especially institutional clients, to choose market places, at least in part, for the purpose of reducing the commission they pay or to take advantage of opportunities to purchase various services with soft commission dollars by means of reciprocal practices. If the fixed commission rate has in fact contributed to the fragmentation of our securities markets, then its removal may well put an end to that trend and hopefully preserve the centrality of interest and concentration of order flow necessary to provide depth and liquidity in a market increasingly affected by institutional participation.

The achievement of a system for efficient execution of securities orders is more likely to arise in an unfixed rate environment where there is an incentive to reduce costs, at all levels, to remain competitive and where access to a market center is largely determined by economic measures instead of regulatory fiat. Moreover, we are very close to seeing in full operation a composite tape, reporting last sale data in transactions in listed securities regardless of whether they are executed on a primary or regional exchange or in the third market. Last week the Commission sent a letter to each exchange informing it that restrictions on the availability of quotation information disseminated by exchanges should, in the Commission's view, be removed no later than May 1, 1975.

Furthermore, progress toward the achievement of a modernized system for processing securities transactions is going to be accelerated as we move toward the unfixing of commission rates. The ability of firms to accomplish their settlements quickly and at low costs is vital to them in the competitive rate era and the outcry for a unified national system for clearing securities transactions is constantly being made. Already a large number of interfaces have been accomplished linking together the nation's securities clearing corporations and depositories. Procedures for clearing have been improved, most recently in the changeover by the NYSE's clearing system to the continuous net settlement approach. The clearing facilities and depositories are now able to capture a good part of the securities movement throughout the financial community, and from the reports I receive, are doing it well during these high volume days.

These seemingly disparate steps of competitive rates and greater disclosure of market information, all of which are being accomplished with little or no affirmative government action, should do much to create the efficient market that we are all seeking. The structure and functioning of our securities markets have historically been the result of private efforts. The Commission's approach preserves the concept of the evolution and development of our capital markets through natural economic process with maximum reliance upon cost considerations and the needs of the users. A specific design approach mandated by the government is something I feel we should avoid if at all possible.

Understandable, May Day will bring apprehension to many in the securities business, a change of this magnitude can hardly be expected not to engender such feelings. But there will also be new opportunities, and I hope they will be seized upon by the industry to improve, strengthen and modernize our capital markets.