BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 27, 19[illegible]

To Chairman Burns

From John D. Stoffels

Subject: SEC action on proposed NYSE commission rates.

The SEC announced on Thursday of last week its action on the New York Stock Exchange's proposed revision in commission rates. While the SEC officially "approved" the proposal, it made so many qualifications as to essentially reject the plan. Mainly, these qualifications would:

-- reduce the commission on all orders up to 200 shares below that proposed by the NYSE,

-- eliminate fixed minimum commissions on all orders above $100,000, substituting instead negotiated rates,

-- require proposals for further change in mid-1971, including a uniform system of cost and revenue accounting, a plan for scaling commissions on dollar amounts of trades rather than on share, a revision of the present method of inter-member clearing charges, and a proposal for reduced commissions charged to non-member firms directing orders to the NYSE through member firms.

The proposal made by the NYSE in June would have generated approximately $550 million in additional revenues, an increase of some 29.8 per cent. As amended by the SEC, and assuming no change in the revenues generated on orders above $100,000 in value--that is, assuming the commission rates on such trades remain effectively the same as they are at present when they become negotiated--an estimated $450 million in additional revenues would be raised, still an increase of nearly 25 per cent.

Since this estimate assumes no change in large order revenues, the retail brokerage houses which have been in the greatest financial difficulty during 1969 and 1970 would effectively be the recipients of the entire increase in revenues. No breakdown of commission revenues into those generated by large order (above $100,000) and those generated by smaller orders is available, so it is not possible to determine the average percentage increase in revenues for those firms concentrating their business in smaller orders. It is clear, however, that the percentage revenue increase will exceed the 25 per cent aggregate figure. Depending on the composition of revenues at a firm, the increase could conceivably range as high as 40 per cent.

Perhaps the greatest controversy over the SEC action relates to the imposition of negotiated rates on large trades. The common complaint is that commission revenues from large trades are bound to decrease if made competitive and jeopardize the financial viability of the institutional trading houses. The fact is that commissions on large trades are already effectively negotiated in a number of ways despite the fact that fixed minimum commissions presently apply. In order to make "commissions" more competitive, firms obligate themselves to provide reciprocal business to other broker dealers on behalf of their mutual fund or other institutional clients, or agree to maintain sizable compensating demand deposit balances at client banks. Through their commission rate hearings and informal interviews in the brokerage industry, the SEC staff have estimated that about 40 per cent of commission revenues on large trades are "distributed" in some way to others, and only sixty per cent retained. Furthermore, on large block trades where the price of the trade is negotiated, an institutional broker-dealer firm is free to quote more favorable prices and perhaps even incur a trading loss on his block position as a means of effectively reducing the commission on the trade.

If the awkward mantle of fixed minimum commission is removed from large trades, it is reasonable to expect--as the SEC staff does--that commission "rates" on large trades will decline. But at the same time, practices that served to reduce the previous fixed commissions will disappear. In effect, according to analysis of the SEC staff, commission revenues on large trades could decline 40 per cent without reducing the net revenues from large trades at all.

The imposition of negotiated rates on large trades would not be expected to have a material impact on the revenues of troubled retail firms. In a study of the 10 largest retail broker-dealers, the SEC determined that 88 per cent of revenues in these firms were generated from orders of less than $100,000. For smaller retail firms, the concentration in orders of less than $100,000 would be expected to be even higher.

In summary, the SEC's alteration of the NYSE commission proposal still appears to provide a healthy increase in revenues for retail broker-dealers. At the same time, it recognizes that the application of minimum commission rates to large trades is both cumbersome and ineffective. Moreover, the recommended abolition of fixed commissions on large trades reflects the acute interest of the Department of Justice in the likelihood that the maintenance of such a schedule could lend to anti-trust action (the Justice Department had originally urged strongly that any order above $50,000 in value be subject to negotiated commissions).

In reaching their final position, the SEC has drawn on considerable public testimony as well as on analysis of the revenue and cost structure of the brokerage industry. It is difficult to find fault with their conclusions on economic grounds; indeed the proposal has considerable merit from an economic point of view. Whether the level of rates proposed for smaller trades will adequately increase the revenues of retail broker-dealer firms cannot be determined from the data available to us; the difference between the NYSE and SEC proposals on these rates, however, is small.

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This analysis reflects both published accounts of the SEC action and discussions with members of the SEC staff. Contrasting views on the appropriateness of the proposal would likely be expressed by industry and Exchange representatives; these comments are summarized in a memorandum from Mr. Keir. Attached are copies of articles on the SEC action that have appeared in the press in recent days. The discussion in this memorandum should be considered confidential since it in part reflects information obtained in confidence from the SEC.

ATTACHMENTS