

EDITORS: The following material is embargoed for use
at 10:30 A.M., EDT, Monday, August 19.

Please observe the release time and date.

STATEMENT OF ROBERT W. HAACK, PRESIDENT
OF THE NEW YORK STOCK EXCHANGE, BEFORE
THE SECURITIES AND EXCHANGE COMMISSION
IN THE MATTER OF S.E.C. RATE STRUCTURE
INVESTIGATION OF NATIONAL SECURITIES
EXCHANGES — AUGUST 19, 1968

I am Robert W. Haack, President of the New York Stock Exchange.

Prior to assuming my present position in 1967, I served for three years as President of the National Association of Securities Dealers. My career in the securities industry began in 1940, and includes experience in sales, underwritings, and administration.

The New York Stock Exchange welcomes this opportunity to explain why the minimum commission structure should be retained, notwithstanding the suggestion for its abolition by the Department of Justice. Our testimony will emphasize the need for a minimum commission framework to assure the proper functioning of the auction market for transactions executed on the New York Stock Exchange.

While we will defend the minimum commission structure, we are not defending the status quo. I have stated publicly, on several occasions, that the current minimum commission rate is ceasing to be a minimum because of practices that have developed and are proliferating in the institutional area. Testimony in the seven weeks since these hearings began has served to document this fact. It should be noted, however, that give-up practices only began to approach their present magnitude within the past six or seven years, and were not a major factor in the industry when the Exchange's commission structure was last revised in 1958. We must not lose our perspective when considering the erosion of present minimum commission rates in recent years by give-ups. In 1967, only 4 to 5 per cent of New York Stock Exchange commissions were given up.

In response to an invitation to comment on the SEC's proposed rule 10(b)-10 which dealt with the give-up problem, the antitrust division of the Department of Justice submitted a memorandum questioning whether a minimum commission rate is required or justified by the objectives of the Securities Exchange Act.

The memorandum is based upon an erroneous assumption - that standard competitive concepts applicable to a typical manufacturing business can be applied without modification to the securities industry. Proceeding from this assumption, the memorandum ignores the underlying purpose of the intricate regulatory and rate-making system mandated by Congress in the Securities Exchange Act of 1934. It pushes aside the 35 years of self-regulation, with SEC oversight, and the industry-SEC efforts to protect investors and strengthen our markets.

In effect the Department of Justice, applying theoretical concepts

without supporting facts or economic data, suggests termination of a pricing system approved by Congress, the SEC, and the courts. This is a system subject to scrutiny by the Congress and the SEC, which has enabled the industry to meet the demands of the investing public by providing a well-regulated liquid market in depth, with supporting research and information services. If, in spite of the success of the present system over a 35-year period, the Department of Justice believes the minimum rate structure should be abandoned, then, I submit, the Department of Justice should make its plea to the Congress and there bear a heavy burden of proof.

The time for expounding theory is past. One does not remove the keystone to an industry which is responsible for billions of dollars of public money, which operates the largest securities market in the world, and which facilitates the raising of the bulk of new capital for this country without presenting irrefutable evidence. We are dealing with a delicate mechanism. This is not an area where one experiments, tries a new system and returns to the old if the results are unsatisfactory. Destruction of the minimum commission would produce irreversible consequences. An erroneous decision will have far-reaching effects. I am sure the Commission shares our view that, in this area, one must proceed with extreme caution.

While we believe the Department of Justice must be required to support its theoretical assumptions, the New York Stock Exchange is nonetheless prepared to discuss the central issues. These are:

- a) whether negotiated commission rates would impair the effective operation of the Securities Exchange Act; and
- b) whether the nature and structure of the securities business evolving from such a basic change in rate determination would be in the public interest.

The Exchange believes minimum rates are crucial to the many advantages the central auction market now offers. These include assurance of fair prices; effective regulation dealing with disclosure, manipulative practices, compliance and surveillance; and the provision of important information, research, advisory, and communication facilities by member firms.

While no one can predict with precision the consequences of abolishing minimum commission rates, I have no doubt that the securities markets as we know them today would cease to exist. On the basis of the economic characteristics of the brokerage business, which the Exchange will analyze in detail in these hearings, it is evident that unregulated commission rates would seriously weaken the Exchange, undermine the stability of the securities industry and greatly reduce established safeguards for the protection of investors.

These conclusions are documented in "Economic Effects of Negotiated Commission Rates on the Brokerage Industry, the Market for Corporate Securities and the Investing Public." This is a 137-page economic analysis by the Exchange which will be offered for the record later in these hearings. One of the crucial judgments of this study is that negotiated rates could bring on what economic textbooks describe as "destructive competition" in periods of declining market volume. This does not mean "ruthless," or "cutthroat," or "unfair" competition - descriptions used emotionally and without documentation by businesses suffering the impact of competition on prices and profits, even though customers benefit from the price rivalry. The concept we are referring to is a valid, recognized economic exception to free competition because the unique characteristics of the industry mean that the customer would suffer as well as the entire

nation's allocation of resources. The securities industry is prone to "destructive competition" whenever there is a weakening in demand, for the following reasons: 1) Commissions could be driven down to levels insufficient for many firms to cover fixed costs; 2) Reductions in commissions would not tend to increase demand or volume but would eliminate many firms regardless of efficiency; 3) Fixed costs - such as rent, computer charges, clerical costs - are relatively high compared with variable costs such as salesmen's compensation, meaning that price competition could lead to large and protracted losses and erosion of capital; 4) Demand - or volume - is highly volatile and most unpredictable - yet firms must provide excess capacity in slack periods to meet the instantaneous demands of sudden, heavy volume.

It is not even clear, as our testimony will show, that investors would realize net savings from negotiated commissions. But, even assuming there were commission savings, the overall cost to investors and the industry may exceed any savings in commission. The effects, as will be detailed in our testimony, can be summarized as follows:

.. Unregulated rates would allow brokers, as well as the public, to negotiate commissions. Brokers wanting to execute orders on the Exchange floor would only have to agree on an appropriate rate with a floor broker. With floor execution subject to negotiation, firms would have little incentive to retain Exchange membership. Brokerage firms would take their orders to the floor only when they could not be executed as crosses in their offices or as principal trades in dealer-created third markets. The avoidance of stringent self-regulation and economies realized from non-support of NYSE operations would be strong secondary incentives for firms to leave the Exchange. What we foresee, then, is a shrinking of the Exchange to a mere association of floor brokers and specialists.

... A proliferation of over-the-counter markets in listed stocks would follow. As specialists lost trades in more active stocks to dealer markets, their ability to provide liquid markets in these issues would diminish. This decline in the specialist system would be the first step in the weakening of the overall central securities market. As more trading moved into brokers' offices, a maze of prices for listed securities would follow. This, plus the absence of tape prints for many transactions, would make it increasingly difficult for buyers to know whether they obtained a fair price. They would not even know whether executions that should have been made were missed altogether. Statistical studies have shown that splintered markets mean wider spreads in stock quotations and poorer market pricing.

.. By giving rise to destructive competition, negotiated rates would eliminate in particular the smaller firms, regardless of their efficiency. Many highly efficient firms dependent on public commission income would be forced out, while a number of less efficient firms, because of their size or diversification, would survive. The culmination of such a competitive race would be the erosion of capital and increased industry concentration, without the advantages of greater efficiency.

.. Negotiated rates would discourage firms from taking on additional fixed costs needed to meet peak demands of heavy volume. The paperwork problems in the markets over the past year have shown that the industry is already seriously deficient in this capacity. Yet the more progressive a firm is in undertaking fixed investment needed to handle heavier volume, the more susceptible it would become to destructive competition in a period of falling volume.

.. Minimum commission rates have enabled firms to provide investors with a flow of financial information, as well as important research,

advisory and communications facilities. Negotiated rates probably would eliminate most of these services as firms assumed the role of discount houses for the mere execution of orders. While the Justice Department has asserted that customers can pay separately for these services, it seems apparent that investors most in need of research and information would not avail themselves of it. There is a serious question whether member organizations would be able to continue to maintain these services. Abandoning minimum commissions would also reduce the incentive of firms to continue to provide services in areas remote from large cities.

.. During periods of slack volume and vigorous rate competition, institutions would be able to exert their bargaining power to force their commission rates down to the lowest possible level. With such pricing, institutions would be making little or no contribution to overhead expenses. The result would be to shift these costs to small, less powerful investors. Discriminatory rate problems would arise, perhaps to the extent that federal authorities would find they have merely traded one problem for another: namely, the policing of discriminatory pricing in place of regulation of minimum commission rates. The Justice Department has indicated that it may be necessary to set maximum rates, presumably to avoid such a shifting of costs to small investors. Yet this would involve the same kind of problem which, as alleged by the Department, makes minimum rate-setting so difficult. Negotiated rates and decentralized markets also would favor institutions and speed the institutionalization of the market.

.. With a seriously weakened Exchange and a fragmented securities market, chances for consumer exploitation would increase. A splintering of the central auction market would mean far fewer firms contributing to

the cost of self-regulation. The quality of market surveillance would sharply decrease.

It cannot even be said with certainty that negotiated rates would result in net savings to investors. What may be saved on commissions might be lost in poor executions. As trading moved into brokers' offices, it is doubtful that brokers would be able to check each splintered market to get the best price for each customer. Because of the limited volume of his business, the small investor would stand to receive the poorest executions.

Regulated rates are not unique to the securities industry. Limits on competition among financial institutions entrusted with public funds are well-known. Exchange member organizations dealing with the public hold some \$66 billion in customers' securities and owe some \$3 billion in credit balances to customers. There is an important similarity between the financial obligations of brokerage firms and those of other regulated financial institutions which must maintain their ability to meet contractual obligations.

Congress has long recognized the potential danger of unregulated interest rate competition to the solvency of individual banks and the soundness of the entire banking system. It has either required or authorized the Board of Governors of the Federal Reserve System to set the maximum interest which banks can pay on deposits. Interest rate ceilings, branching limitations, investment restrictions and the like are imposed today not only on commercial banks but also on the thrift institutions - mutual savings banks and savings and loan associations. The intention has been to prevent the sort of intense price competition which might prove ruinous to these institutions, their depositors, and the economy as a whole.

Even more important than the ability of the brokers to pay their debts is the issue of public confidence in the integrity of financial organizations.

In the securities field, minimum commission rates have been administered by the Exchange since its founding - and since 1934 directly pursuant to the intention of Congress as expressed in the Securities Exchange Act.

As our subsequent legal testimony shows, Congress in the 1934 Act intended minimum commission rates to be set by exchanges subject to SEC review and revision. Thus no administrative agency can substitute negotiated rates. Moreover, the role of the Exchange in establishing minimum rates has been supported by the SEC in a number of documents, including its 1963 Special Study of the Securities Markets, and in an amicus brief in the Kaplan case. Our legal study shows that the unique regulatory scheme designed by Congress in the 1934 Act would not work without minimum or fixed rates, because, as is demonstrated in our economic analysis, negotiated rates would seriously weaken the Exchange and therefore limit its ability to effectively regulate a significant segment of the securities industry.

The present minimum commission rates administered by the Exchange were established in 1958 and modified in 1959 at the request of the SEC. A brief review of this commission change might serve to show the relationship between the Exchange and the SEC in their joint, cooperative, rate-making activities.

In March, 1958, the Exchange recommended an amendment to its Constitution to increase the minimum commission rates. The amendment was approved by a majority vote of the members in early April, to become effective on May 1 of that year. The SEC on April 14 ordered an inquiry as to whether

such rates were "reasonable" and in accordance with standards contemplated in the Securities Exchange Act. At the request of the SEC, the Exchange submitted detailed data on income, expenses and profits of member organizations and other financial information. After its own study of this material, the SEC requested the Exchange to reduce certain rates at the lower end of the scale by 5% and to eliminate the "round turn" discount. The SEC also requested Exchange adoption of a rule requiring 30 days public notice before any action by the Board of Governors on commissions and provision for further studies and consultations with the SEC.

Following meetings with the SEC, the Exchange complied with all requests. In February, 1959, the Exchange Board of Governors approved constitutional amendments effecting the changes and authorizing the studies requested by the SEC. The following month, after a majority vote by the members of the Exchange, the changes requested by the SEC became effective.

Obviously, the dynamics of the securities industry have changed greatly since 1958 and call for suitable changes in the commission structure. The number of direct stockholders has doubled, to 24 million. Average daily volume on the Exchange has gone from 3 million to more than 12 million shares. Institutions' share of NYSE volume has jumped from 23 per cent to more than 33 per cent. In the same decade, U.S. population has increased from 175 million to more than 200 million. The gross national product moved from \$447 billion in 1958 to \$851 billion.

By the same token, commission practices that were not a major factor in 1958 now have a direct bearing on the Exchange's commission structure. The Exchange for some months has been working toward a revised structure that will recognize these changes.

It is one thing to revise the commission structure to reflect changes that are taking place in the industry. It is quite another to eliminate the commission structure altogether. The present system of trading stocks, within the minimum commission structure, has contributed to public confidence, to efficient resource allocation, to economic stability and growth. I believe our testimony, which is based upon the cumulative operating experience of our member organizations, will expose the weakness in the Justice Department suggestions.

Appearing for the Exchange will be Professor Richard West, Associate Dean of the Cornell University Graduate School of Business Administration, who will testify on economics of the central auction market.

.. Mr. Frederick Barton of Eastman Dillon, Union Securities and Company, Chairman Levy and I will testify on incentives to Exchange membership.

.. Dr. William Freund, Vice President and Economist of the New York Stock Exchange, will present the Exchange's economic analysis, testify on investor information, research and advice, and on the public interest in brokerage firms as financial institutions.

.. Professor Charles Phillips of Washington and Lee University will testify on destructive competition.

.. Mr. Harry Jacobs of Bache & Company and Mr. Alexander Yearley of The Robiason-Humphrey Company Inc., Atlanta, Ga., will testify on fixed costs of brokerage firms.

.. Mr. Morris Goldstein of Francis I. duPont & Co. will testify on investor needs and willingness to pay.

.. Dr. Irwin Stelzer of National Economic Research Associates will

testify on the formulation of standards of reasonableness for commission rates.

.. Mr. William Jackson of Milbank, Tweed, Hadley and McCloy will present the legal basis for the minimum commission.

(END ADVANCE FOR 10:30 A.M., EDT, MONDAY,
AUGUST 19 -- PLEASE NOTE DATE)