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(202) 755-4846

FOR RELEASE

INTERIM REFLECTIONS ON MAYDAY

Remarks by

A. A. Sommer, Jr.*

Commissioner

Securities and Exchange Commission

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We are now approaching the end of what may well have been the most momentous month in the history of securities regulation. On the first day of this month, the hallowed practice of fixed retail commissions on securities exchanges in this country came to an abrupt end. Now, near the end of the month, the President is about to sign the most far-reaching reform of the securities legislation in this country since 1934. Now starts the arduous, complicated and challenging effort to transform the legislative mandates of this legislation into policies and practices not only at the Commission but on the exchanges of the country and throughout the industry.

I would like to report to you today on the securities world as I see it at the moment in consequence of the first of these two momentous events, the elimination of fixed commissions.

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First, Mayday. Billed shortly after May 1 as a "non-event", certainly no one who has observed the scene in the securities industry since then would say that was an apt description. True, at the moment that observation was made, it did appear the transition to competitive commission atmosphere was being made with relatively little distress and distortion. Since then, however, it has become evident that the elimination of exchange rules fixing minimum retail commissions is having a profound impact with consequences that are not presently measurable with any assurance.

First, I think it is interesting to review briefly the history of fixed commissions and what patterns had developed prior to May 1.

Fixed commissions go back to 1792 when a very small group of brokers doing business on the New York Exchange, which then interestingly enough was somewhat secondary in importance to the Philadelphia Exchange, agreed under the legendary Buttonwood Tree in the Wall Street area that they would all charge the same price to members of the public and would give a preference to each other. That system of fixed commissions in large measure endured until May 1, 1975. During the intervening years other exchanges adopted the same practices and in the over-the-counter market agency transactions were generally handled for the same commission as that prevailing on the New York Stock Exchange. In 1934, when it enacted the Securities Exchange Act of 1934, Congress gave to the Commission fairly broad power with respect to a variety of exchange matters, including the reasonableness of commissions. This particular oversight function of the Commission was until late in the sixties rarely exercised actively: proposed adjustments in commissions were submitted to the Commission which generally routinely registered its non-objection. Until 1968 there was no recognition in the Commission structure of the size of a transaction: if you were buying or selling ten thousand shares of stock, you paid the same commission per one hundred shares that you paid if you were buying or selling simply a hundred shares. In 1968 the volume discount developed, but the extent of this discount was, again, fixed. Thereafter in 1971, under pressure from the Commission, and after extensive litigation had been initiated to test the legality under the antitrust laws of the fixed commission system, the exchanges commenced giving discounts on the portion of orders that exceeded $500,000. In 1972, this figure came down to $300,000. Very quickly patterns of discounting on portions of large orders over the upper margins developed. At first the discount from the previously fixed commission was approximately fifty percent. The amount of this discount gradually diminished until finally during the latter days before May 1 it had settled into a pattern of thirty-five percent off. Obviously, it was the institutions which were mainly able to take advantage of these discounts.

Again, under pressure from the Commission, in 1971, the exchanges began making available to non-members a so-called "access" discount. Previous to this time brokers who were not members of an exchange, principally the New York Stock Exchange, paid members to execute transactions for their customers the same price that a member of the public paid the exchange member for executing his transactions. Thus, if the non-member were to make any money or even cover his expenses in connection with the sale, it was necessary that he charge his customer something in addition to the commission he paid the exchange member. Obviously this would operate as a severe detriment to the customer of the non-member since in effect he was paying for the same service twice: the commission charged by the exchange member was designed to cover such services as research, custody of certificates, salesman's compensation and all the other services that were bundled in this single charge. This inequity gave rise to the so-called non-member access discount under which brokers who were not members of an exchange were able to get a 40% discount; thus, they could charge their customers the same price as the exchange member charged his customer and have 40% of the commission to cover their own expenses and possibly make a few cents.

Now there is one other aspect of the fee structure just prior to May 1, 1975 which I think should be noted. This is the so-called floor brokerage: the charge that an exchange member with a presence on the floor of an exchange would charge another member who did not have presence on the floor of the exchange for executing his business there. For instance, if broker A had a customer who wished to buy a thousand shares of AT&T, but broker A, while a member of the exchange and while owning a seat, nonetheless did not regard it as economic to maintain a man on the floor, he would channel his customer's order to another member which did have someone on the floor. This member on the floor would take the order to the appropriate post, cause it to be put on the specialist's book or have it executed at market. For this service the floor broker charged a commission, also a minimum price fixed by the exchange's rules, which generally was about eight percent of the total retail commission. Thus, if the commission on that thousand shares order was $100.00, $8.00 of it would be paid to the executing broker on the floor and the remainder of the commission would belong to the broker who acted directly for the customer. If the order was a limit order and thus would be placed on the book of the specialist, when it came time to execute the specialist in effect acted as the floor broker and received that part of the commission. I should note that floor brokerage may continue to be fixed until May 1, 1976, but several regional exchanges have eliminated it already in an effort to secure a competitive advantage over the New York Stock Exchange.

As has been characteristic of fixed price systems from time immemorial, various means of avoiding the inflexibilities of this commission arrangement began to appear. Regional exchanges, always at something of a disadvantage with respect to the New York Stock Exchange in dealing with dually listed securities, relatively recently began to open their doors to brokers which would not be eligible for membership on the New York Stock Exchange, for instance, affiliates of institutional investors. Then, an institutional investor with a seat on a regional exchange could arrange with a New York Stock Exchange member that in exchange for giving that member New York Stock Exchange business, the New York Stock Exchange member would give to the institutional affiliate on the regional exchange a certain amount of business for execution on that exchange. This practice, which was known as regular-way reciprocity, developed into rather precise formulations. The ratio generally gave two dollars of New York Stock Exchange business for one dollar of regional exchange business. The institutions bargained for, and got, more favorable ratios. Increasingly, institutional investors went to the third market where there were no fixed commissions and found there other advantages besides flexibility of compensation which were generally not available on exchanges. The principal beneficiaries of these various means of avoiding the impact of fixed minimum commissions were, of course, the institutions rather than individuals; for the most part, individual investors continued to pay an uncomplicated minimum commission.

Increasingly, the structure was not only subverted by these practices and others as well, but in addition it was subjected to rather careful legal and economic analysis. In 1963, the Supreme Court had decided the case of Silver v. New York Stock Exchange and for the first time indicated the limitations on the antitrust exemption that the exchanges enjoyed as a result of the '34 Act. In that case the court indicated that this immunity was not blanket and that when exchanges engaged in practices which, but for the 1934 Act would be regarded as violations of the antitrust law, they would have to be justified on the basis that they were necessary to make the regulatory scheme of the '34 Act work. With this limitation now established, the fixed commission practice quickly came under the gun. Suit was filed in the District Court in Milwaukee. That action, after one bout in the Court of Appeals for the Seventh Circuit, was returned to the District Court for trial. Trial has been held and a determination by the Court is now pending. Another case was filed in New York against the New York Stock Exchange. In that case a minimum commission system was upheld by the District Court and the Court of Appeals and the case has now been argued and submitted to the Supreme Court.

Studies began to be made of the fixed minimum commission system and the impact it was having on the securities markets. It was evident that the commission charged bought a whole host of services. By the payment of the fixed minimum commission an investor received whatever services a salesman might render and usually the salesman received a third to a half of the total commission for his efforts. He received such research services as the firm had available, he had the benefit of his securities being kept in safekeeping and his dividends remitted to him and he enjoyed several other professional services. In many instances investors did not want all of these services; particularly institutions provided many of these services for themselves and did not appreciate paying again for them.

In 1971, Congress began a review of the whole structure of securities regulation in the wake of the back-office debacle of the late sixties and early seventies and the failure of many securities firms. In the course of its hearings there was much testimony concerning the fixed minimum commission practice and its impact on the industry and on the securities markets in general. When these hearings ended legislation was drafted in both the House and the Senate which rang the death knell for fixed commissions. While the formulations of the elimination and the timetable for it varied between the Houses, both pieces of legislation looked toward the eventual elimination of the system.

The legislation as finally adopted includes a bar on fixed retail commissions, although the Commission is given the power until November 1, 1976 to reinstitute such commissions in whole or in part through a rather simple procedure and thereafter by means of a very complicated procedure.

However, the Commission anticipated this action by Congress when on September 11, 1973, in connection with granting an increase in the fixed minimum commission to the New York Stock Exchange, it ordered the exchanges to take appropriate action to eliminate fixed minimum commissions on or before May 1, 1975. The exchanges refused to do this. As a result the Commission had a so-called 19(b) hearing at which all interested parties were invited to express their opinions and present information bearing upon the question, after which the Commission adopted a rule, Rule 19b-3, which in effect eliminated fixed commissions with the exception of floor commissions which were mandated to be unfixed not later than May 1, 1976.

Those who opposed the elimination of fixed commissions expressed several fears. First, they feared that with the elimination of fixed commissions the bargaining power of the institutions would drive down prices to uneconomic levels that would destroy large parts of the securities industry. Furthermore, they were concerned that the research capacity of the securities industry would be seriously undermined. As is evident from the differential between the retail commission and the commission that a member would pay for the execution of his transactions on the floor of the exchange, there was considerable "fat" in the retail commission structure. Many firms began using a part of this fat to finance extensive research activity which they would then market to institutions in exchange for the institution providing them with business. Many of the established full line firms developed substantial research capacity in this fashion; in addition to that, however, there developed a number of houses which became known as "research boutiques", almost the entire business of which consisted of dealing with institutions and providing them with research in exchange for orders to execute transactions. It was feared by many that as commission prices were driven down by competition, there would not be left a sufficient amount over the cost of execution to continue to finance these research services. This controversy became a very complicated legal one with discussions focusing upon the extent to which a fiduciary might pay to a broker some amount over and above that which was necessary in order to secure an execution in exchange for research services. An effort has been made in the legislation that has now been enacted to clarify this by expressly providing that any state or federal law to the contrary notwithstanding, unless enacted after the legislation, it would be legal for a fiduciary to "pay up" for research services.

The Commission never believed that Mayday and after would be "wine and roses" for the securities industry; rather, we recognized that in all probability there would be some reductions in the prices charged institutions for brokerage services, that some firms which were inefficient or poorly managed might suffer economic detriment and that conceivably there would be consequences not foreseen by us. Because of the fact that probably no price fixing system as pervasive as this one had ever been terminated as dramatically, forthrightly and completely in one administrative sweep, the Commission developed a fairly elaborate monitoring system to give it the benefits of as up-to-date and timely information as we could concerning the impact of these changes. Among other things, we are monitoring closely the extent to which there is a change in the markets in which investors are doing business: is the New York Stock Exchange recovering some of the business that drifted off to regional exchanges and the over-the-counter market because of the inflexibilities of the commission structure? We are monitoring the revenues and profits of the securities business: to what extent are securities dealers losing revenues? We are analyzing the revenue and profit information not only of the industry in general but of various segments of it: institutional, individual, research boutiques, and so on. In addition to that, and perhaps more important even than the formal monitoring program, the Commission is receiving, almost like an army headquarters, daily information from many points around the country about patterns that are developing, the way business is being done, the extent to which discounts are being given, the impact of various changes in the pricing structure. We are also discussing the information which is being received by the Treasury Department which similarly is in close contact with key members of the securities industry and with key institutions. Thus, we do not think we are in any measure in the dark about developments; on the contrary, I would suggest that we are as fully informed during these swiftly changing days as anyone could possibly be.

Commissions have gone through several phases already since Mayday. During the first few days after the onset of competitive commissions, it appeared that the principal change was occurring in the price at which brokers were willing to execute so-called "no-brain" orders of institutions, that is, one-hundred to five-hundred or a thousand share orders of stocks enjoying considerable trading activity. With respect to these the discounts initially ranged as much as fifty percent off the previously established minimums. This in itself was not particularly surprising. After all, as I mentioned, a third to half of the commission was usually paid to the salesman who took the order. For these orders there was little need for a salesman's intervention, hence, it is not surprising that that element of the commission washed out early. It appeared initially that the commission on larger institutional orders might remain relatively stable. Some of the large full line houses which were heavy in institutional business announced the extent to which they would be inclined to discount and it appeared for the moment that the line might be held at that point. That hope quickly perished last week when, faced with increasingly deep discounts from predominantly execution houses on larger orders, the prestige houses that had previously indicated unwillingness to do business at bargain basement prices cut their prices considerably, and, in some cases, indicated they would go to any price in order to be competitive. It is probably not an exaggeration to suggest that the pricing patterns last week were disorderly, even chaotic. Increasingly, those who had opposed the elimination of fixed commissions began to see their worst fears confirmed.

It should be noted that at least for the moment the price charged to individuals has remained fairly firm, at or in some cases slightly above and, for certain packages of services, slightly below, the minimum which had been prevailing prior to May 1. Whether this line will continue to be held is by no means assured. It seems only a matter of time before some houses begin to urge individual investors to take advantage of the opportunities that now exist for the first time to secure cheaper executions. Against this possibility are a number of countervailing factors. For one thing there is every indication that commissions are a relatively small consideration in the judgment of an investor. For the most part they have been remarkably uncomplaining in the face of several increases in recent years. Secondly, with their situation uncomplicated by fiduciary considerations, they can more confidently pay amounts that appear to be in exchange for research services. Thirdly, in many instances, there exists a close relationship between a particular registered representative or firm and a retail customer which the customer is unwilling to disrupt for the sake of a few cents a share advantage. Finally, the individual appears to be far more interested in overall profitability than a few extra cents a share on the commission and will not shop for that saving if he is otherwise satisfied with his broker.

However, I think it is not likely that at some point there will develop a pattern of discounting for individual orders which may prove to be infectious and which many firms will be compelled to follow in order to maintain and perhaps expand their clientele.

As for the institutional orders, it is very difficult at this time to predict what patterns may emerge. Prior to May 1, I had said on a number of occasions that I expected a period of three to six months to pass before the situation stabilized. It would seem to me that that prediction is still a valid one, if anything, more so. I would suspect that as the large firms match the discounts which brought unprecedented amounts of business to smaller firms that engaged in deep discounting, it will become apparent to those firms that they have provoked a game which they cannot win against large, well-capitalized, full line firms. When that realization becomes widespread, it may mark the bottoming out of commission discounting and it may be the point from which commissions begin to recover somewhat.

At the moment I would suspect few, if any, firms have begun any deep study of the structural changes which they should make in their businesses as a consequence of events since May 1. If deep discounting continues for a significant period of time, obviously most firms will begin to reexamine their participation in the commission business and make judgments about the manner in which they expect to conduct it, if they plan to continue conducting it at all. At that time I would suspect some firms which derive only a small portion of their revenues from commission business may decide to forego it completely; others may decide to eliminate whatever research activities they have and concentrate solely on execution; some firms that are predominantly in research may seek amalgamation with larger firms which have a broader mix of business. In any event I think it is too soon to expect these determinations to surface, but at some point obviously firms are going to have to address themselves to these questions if their revenues continue to suffer sharp erosion.

In public addresses prior to May 1, a number of people, including Chairman Garrett and myself, remarked that in all probability the onset of competitive commissions would induce structural changes in the industry, including perhaps the demise of some firms which were unable to compete in a competitive price environment. None of us welcomes this or wishes it, but we simply must in all candor recognize it as a possibility. It seems to me, unfortunately, that that prophecy may still be borne out and by the end of this year it may well be that some firms will decide that they can utilize their resources and their members utilize their talents otherwise than in the business they are conducting at the present time.

As I indicated earlier, one of the pervading concerns has been that large institutions, possessing enormous bargaining power, would drive down commissions to ruinous levels. While commissions have gone down considerably, it does not appear that this has been the consequence of institutional pressure. Rather, members of the securities industry, in an effort to better their competitive position, without pressure from the institutions, dropped commission levels significantly and not unexpectedly institutions stepped forward and took advantage of the bargains that were offered to them. At the moment there is very little incentive for institutions to pay more than the low commissions that are offered to them. In many instances these low prices are offered by firms which give no research benefits to their customers. Any disadvantage which an institution may suffer as a consequence of the limited services they receive in exchange for their commission dollars is probably not yet apparent. To some extent research that was made available prior to May 1 still has relevance and undoubtedly is still in use. Beyond that, the information I have received would indicate that many houses - in fact most of them - are continuing to make available their research product to customers with thom they previously had relationships, even though those customers may presently be directing large portions of their business to houses with which they previously did not do business. If a continued period of extremely low commissions results in sharp cutbacks in research activity by full line houses and the disappearance of so-called research boutiques, at some point, the diminution in the quantity and quality of research will become apparent to portfolio managers. At that time, it may well be that institutions, to the extent that they value street research, will commence a review of the activities of their traders and review their legal position to determine whether in fact they might not wisely and legally pay more than the rock bottom prices at which traders are doing transactions in order to renew relationships that have given rise to valuable research activities in the past. It may well be that this kind of review will come only after there has been lost to the street, and indirectly to the institutions, a significant amount of the research ability that is presently available. If that happens, I think it would be extremely unfortunate. It seems to me the time for portfolio managers to pay attention to the impact of low commissions upon the continuation of good street research is now, and not after a significant fragment of that research ability has been lost, perhaps to an extent not susceptible of easy restoration. There is some evidence that at the moment the determination of commissions is being left almost exclusively to traders. It is not the traders of institutional investors who know the value of street research; the persons who know are the portfolio managers. I would suggest the portfolio managers should concern themselves to a greater extent than it appears they have with the problem of commissions; they should review their legal position in the light of the legislation which is about to be enacted, and they should determine responsibly whether the negotiating practices of their traders are in the long term best interests of their institutions.

The Commission is asked whether it will take action as a result of the monitoring program and if so, what action will it take. It is sometimes suggested that we identify the events which might bring about action by the Commission and identify the action which we would take if certain occurrences actually happened. Quite honestly, we do not have contingency plans; we have not determined what action we would take in response to what events. We have indicated that in the event it appears that negotiated commissions brought about markets or situations in the markets, which were inimical to the best interests of investors and inimical to the operation of fair and efficient markets, we might be impelled to take action. I would have to say in all honesty that it would take only the most extreme situation to cause us to reinstitute fixed commissions, in whole or in part, even though we have clear authority under the legislation which has been enacted to do that. It seems to me that there are many alternative courses that we might follow if it appeared that some remedial action were necessary. However I think it would be unfair to the industry and imprudent for us to identify at the present time what actions might be forthcoming.

That the securities industry is experiencing a period of uncertainty, turmoil, and price-cutting is not particularly surprising. It is somewhat surprising to me that apparently historic relationships that prevailed between brokers and institutions have apparently counted for little and a history of past services rendered has been of relatively little significance. I had hoped that perhaps those factors would play a role in a competitive compensation regime and would be counted heavily in the equation used by institutional investors in determining where they should place the business.

I am not disheartened and I think in saying that I speak for the other Commissioners and for the staff. It seems to me - and this opinion is shared by many in the industry - much too soon to draw any secure conclusions with regard to the impact of competitive commissions. There is bloodletting; there is uncertainty; there is experimentation.

All of this is not unexpected. I remain confident that this time of flux will end, that a stability will replace it, and that the introduction of fully competitive rates will yield the benefits foreseen when a year and a half ago we first gave the industry a deadline: a better industry, better markets, greater benefits to all investors. A last word, let us be faithful to the belief, reinforced by years of study by Congress and the Commission, that indeed price competition in this industry, as it does in others, serves the public best.