<u>THE COMMISSION RATE STRUCTURE AND THE INSTITUTIONAL INVESTOR</u>

Remarks by Eugene Miller, Vice President, New York Stock Exchange, at the 1969 Mutual Funds Conference, Sponsored by The Federal Bar Association and Commerce Clearing House, Inc., The Riviera Hotel, Palm Springs, California, Friday Morning, March 14, 1969.

I guess that some of you (ladies and) gentlemen may suspect, from the title of my talk, that I may have brought along a few bones to pick. Well, you're not entirely wrong -- but I hope there may be enough good, solid meat on them to provide some extra nourishment for us all.

As a group, institutional investors -- and mutual fund managers in particular -- are probably the most sophisticated users of the stock market. I've heard it said -- in something of a switch on an old bromide -- that even when they aren't quite sure what they want, fund managers know exactly how to go about getting it.

This may be an oblique way of explaining why you -- and other successful institutional shareowners -- have been attracting so much attention from economists and other expert observers of the market, as well as from the regulatory authorities.

I think we've all seen printed articles describing various aspects of the institutional phenomenon. Some of these have been responsible, well-researched efforts to inform the public. Others, I'm afraid, have not. Too often, the use of "scare" headlines and innuendoes seems to suggest, without documentation, that something unsavory might be going on.

"Are Institutions Taking Over The Stock Market?" is one such headline.

"Are Institutions Gobbling Up The Available Supply of Equities?" is another.

A third loaded question goes something like -- "Are Institutions Misuing Their Tremendous Purchasing Power And Driving The Little Fellow Out Of The Market?"

But while we may object vigorously to the tone of such questions, I think we can agree that there is a serious need for much better information than is presently available before we can offer persuasive replies to those who may be sincerely concerned.

Take a look at what's happened in just five years. Back in 1963 -- it seems like another era, now -- the New York Stock Exchange did not even keep track of trading in large blocks. Late in 1964, we did begin compiling statistics on transactions involving 10,000 or more shares. The first entry in the statistical series -- for the fourth quarter of that year -- shows 399 blocks, totaling less than 9 million shares, with a market value of just under 300 million dollars. Block trading for that quarter represented just under 3% of reported NYSE volume.

By contrast, the figures for the final quarter of 1968 show 3,645 blocks -- totaling almost 100 million shares -- traded, with a market value in excess of 4.6 billion dollars. And this represented more than 12½% -- about one-eighth -- of all reported volume for the quarter.

At the end of 1968, institutional portfolios -- exclusive of bank-administered personal trusts -- held an estimated 155 billion dollars of the 692 billion-dollars-worth of stocks listed on the Big Board. This was up from 133 billion dollars a year earlier, and more than kept pace with a 14% over-all increase in the market value of our List. And while mutual funds' holdings have not been increasing as rapidly as those of some other types of institutional owners -- notably noninsured pension funds and life insurance companies -- it is still a fact that mutual fund holdings have nearly quadrupled in a decade and today account for more than 5% of all NYSE-listed stocks.

Under the circumstances, it isn't difficult to understand why many competent observers of the market have expressed concern -- or why some less-competent commentators have been wondering out loud about the direction of what they regard as a potentially dangerous trend.

This public concern is, frankly, an important factor in the New York Stock Exchange's strong support for the SEC's study of the impact of institutional activity on the market. At the Exchange, we hope that this study, with responsible industry participation, may provide a legitimate basis for allaying the fears which have been expressed about possible undesirable side-effects of institutional activity and growth. And we are hopeful that the findings will bear out our belief that, essentially, what's good for institutions -- and for the millions of individuals they represent -- should be good for the market, too. At the same time, I think that if any genuinely adverse effects are identified, the industry must be prepared to take constructive action to correct them.

In any event, it seems doubtful indeed that the full impact of institutional activity has yet been felt. Consider, for example, that the life insurance industry -- with some 200,000 full-time salesmen and 187 billion dollars in assets -- is just getting into the act. Over 100 life insurance companies are now involved in variable annuities or in some form of mutual fund activity. And, as you are all aware, the men who manage university endowments and corporate pension funds are also shedding more conservative approaches and are showing considerably more interest in performance.

In terms of general market activity, the New York Stock Exchange has taken a hard look at the prospects ahead -- and we have come up with some startling possibilities. We see the likelihood, for example, that the 13 billion shares listed today may increase to 24 billion by 1975 -- and to 38 billion by 1980.

Assuming a normal turnover rate of 18%, average daily volume would increase to 17 million shares in 1975, and to 27 million shares in 1980.

There is a temptation, perhaps, to say, “Gee, that’s great!” But the implications are really staggering. Last year, the NYSE turnover rate was not 18% -- but 24%. Applying volume projections at that rate to the likely increases in our Stock List yields the prospect of 23 million shares a day being traded in 1975 -- and a daily average of 36 million shares in 1980.

Without belaboring the arithmetic, let me just add that, in the latter case, we would expect that on the peak volume day in 1980, some 63 million shares might be traded on the NYSE alone.

Now, 1975 and 1980 are not really that far off in the future. And as everyone knows, the securities industry had its hands full trying to cope with 1968’s daily average volume of 13 million shares. We think we’re finally getting the massive paperwork problem under better control -- and we will be increasingly assisted by our new Central Certificate Service. Except for a few remaining bugs, CCS is now fully operational -- permitting delivery of stocks among brokers by means of a central depository of stocks and computerized bookkeeping entries. We’ve also enlisted the best available outside assistance in planning how we might most efficiently handle future volume loads without a recurrence of the paperwork problem. But all that is material for another talk.

There are many other vitally important questions -- involving fundamental Stock Exchange policies -- which are very close to the interests of the mutual fund industry. The most obvious one, of course, is the Justice Department’s questioning of the minimum commission structure. Another is the issue of institutional membership on registered stock exchanges. A third is the demand of nonmembers for equal access to our markets. And still another stems from the desire of some of our own member organizations to gain access to the public capital markets in order to finance their own expansion programs.

I say to you, frankly, that there isn't an easy answer in the lot.

In considering any of these questions, I think we must begin with the plain unvarnished fact that the securities business is a closely regulated business. It has been regulated by the Federal government -- and by its own organizations -- for three and one-half decades, and it's going to go right on being regulated. Regulation is a plain, simple fact of life for all of us in the industry -- as it is in the banking business or almost any other form of activity involving the handling of other people's money.

There is no point in debating whether regulation is or is not necessary. Even the most intransigent foe of regulation would have to admit, I think, that it has been accompanied by some tangible benefits.

Can anyone realistically suppose, for example, that public confidence would have rebounded -- as it has -- from the disillusionment of 1929 without the securities legislation of the early thirties? And is it not demonstrable that the fantastic growth of the mutual fund industry -- from assets of half a billion dollars to over $50 billion -- dates from the Investment Company Act of 1940?

Realism demands that the regulators recognize the essentiality of our business to the healthy functioning of the economy. Realism also forces us to expect that when conditions in our business change -- when it is subjected to unusual pressures -- the regulators are going to look closely at what's taking place.

On the other side of the coin, I don't see how we -- as self-regulators -- can avoid the responsibility of re-examining our own situation. The whole point of self-regulation is to take the initiative in responding and adjusting to change, and to revise procedures that become outmoded because of change.

Self-regulation -- just like regulation from outside -- must be accompanied by oversight and review. It must be administered with some imagination. And it must be augmented with new powers, from time to time -- even at the cost of some discomfort to those who must grant such powers.

A case in point is the New York Stock Exchange's commission structure changes which went into effect last December. Some people have been critical -- and not at all reticent about expressing their views -- of the volume discount and give-up prohibition which are significant features of the new schedule.

It has been said -- in some cases with considerable vehemence -- that this so-called "intrusion on profitability" was unwarranted. Those of us who were instrumental in formulating the changes reject that view. We believe that they were necessarily responsive to new patterns of trading and to practices that were undermining some business standards of the securities industry. Had those practices been permitted to continue unchecked, the industry itself might have presided over the demise of fixed commission rates which support the high standards of regulation we set for ourselves.

The commission rate changes were the legitimate subject of action by the Exchange. And further, we believe we have the right to -- and should -- determine and implement any additional changes which may be appropriate in the light of continuing developments in the nature and use of the market.

To this end, we have undertaken a detailed study of the entire commission rate structure, looking toward a viable basis for any further revisions. This study, budgeted at more than $400,000, will take between 12 and 18 months to complete, and involves the construction of a scientific sample of all member firm trading during 1969. Each member firm will be reporting

on its orders and transactions for two days during the year, with different dates assigned to each firm. A Transactions Revenue Survey will help clarify the relationship between orders of various sizes and the number of trades usually associated with them. We do not have accurate data at present, for example, as to whether a 1,000-share order usually involves two, three, five or some other number of executions; or whether a 50,000-share order typically requires five, ten or many more trades.

We also expect to assemble more reliable information than has ever been available in the past about who is in the market. This information -- on types of customers, types of accounts, demographic and economic characteristics -- will be helpful outside the scope of the commission-rate question, in the Exchange's and member firms' long-range planning.

We do not, in this study, seek to determine the best commission rate structure for some mythical model member firm. Rather, our aim is to determine a reasonable, industry-wide average of profitability for the securities commission business. We would expect, thus, that under any resulting rate schedule, the profits of an efficiently operating firm would be higher than the norm, while those of an inefficient firm would be below-average or even non-existent.

The job of determining standards is an enormous one. In our business, as is well known, return on capital is not the only standard of profitability. We will be looking, as well, at other measures of return -- including operating margins and returns based on discounted income and expenses.

The range of pertinent questions is almost limitless. What services should be covered -- and what services excluded -- by minimum commission rates? What, if any, other member firm activities -- such as underwriting and arbitrage -- may be considered as providing some income or incurring some expenses relevant to commissions?

As Exchange President Bob Haack pointed out recently, questions like these tend to dwarf such relatively mundane -- if far-from-easy -- ones as defining statistical income and expenses, allocating costs, and relating net income to a proper base for the measurement of profitability.

And beyond all of these questions, there are the overriding issues of giving our member firms incentives to operate with maximum effort to provide an efficient market for investors -- and of anticipating the effect of any major commission-rate changes on the future shape of the securities industry itself.

The complex web of issues becomes still more intricate when we move on to some of the related matters I alluded to earlier. Take, for example, the question of institutional membership on stock exchanges. Doubtless, there are many in this audience who are all for it. But I submit that no one -- as yet -- really can say authoritatively whether it's a good, bad or indifferent idea.

If institutions are admitted to membership, will our member firms be able to continue serving the individual investor? To what extent would institutional membership institutionalize savings and, thereby, adversely affect the ability of the present, highly liquid market to absorb large institutional orders? It is entirely possible that institutional membership, by its effect on market liquidity, would, in the long run, subvert the best interests of the institutions themselves.

Again, even if we assume that institutional membership is a good thing -- how would you distinguish between the right of a mutual fund to become a member and the rights of, say, a nonmember broker-dealer firm to join the Exchange for the sole purpose of trading for its own account? And what should policy be with regard to the wealthy or active individual investor who seeks the same privileges? Here again, I don't think anyone yet knows the answers to the complex question of nonmember access -- despite some clamoring in recent months.

There is, too, the question of permitting Stock Exchange member firms to issue some form of equities to the public as a means of financing expansion. Some of our member firms have been urging the Exchange to do something in this area which is also closely interrelated with the issues of institutional membership and nonmember access. How would one realistically distinguish, for example, between a publicly owned entity calling itself a brokerage firm -- and a publicly owned entity, also entitled to execute its own transactions, that calls itself a mutual fund?

I think it is obvious that none of these issues can be resolved independently of the others. Policies must be developed which will provide meaningful guidelines for dealing fairly and equitably with all of them -- on an integrated, rather than a piecemeal, basis. Nor can we hope to come up with satisfactory answers until we are in possession of all the relevant facts -- the facts we are gathering through experience with our new interim commission schedule, and the facts we expect will be developed by the SEC's institutional study and our own commission-rate studies.

Thus, while we do not have the answers today -- and will not have them the day after tomorrow -- we are hopeful the work being done now may eventually provide us with the detailed information on which to base some really sound, and perhaps far-reaching, decisions.

I think it is pertinent to bring up here another factor which is going to play an important part in any changes we may wish to put into effect. I mean the small, individual investor. Today's markets -- and a good measure of the prosperity they represent -- owe a great deal to millions of individuals whom our industry invited to invest part of their funds in securities -- and who chose to do so. And no matter what pressures may be applied from within or outside the industry, I don't think the New York Stock Exchange is going to turn its back on those people.

Now, before I am misunderstood, let me acknowledge that mutual funds and other institutions do an excellent job for individual investors. Make no mistake about that. They enable additional millions of people to participate indirectly in the market with the benefit of professional management.

But there must always be convenient ways for an individual, if he wishes, to invest in stocks on his own -- without suffering any disadvantages stemming from the efficiency or cost of executing his transactions, or because others have some form of special access to the market.

There are many people -- myself among them -- who believe that if the individual investor were bumped out of the market, the entire concept and function of securities markets as we know them in this country could change for the worse -- and that the liquidity which institutions expect from the central marketplace could suffer drastically. The studies now under way should give us better documentation in this area.

From all of the foregoing, it should be clear that whatever changes may be in store, the essential concern of the New York Stock Exchange is to preserve and enhance broadly based securities markets in which liquidity is the key element.

And in this connection, I think it is essential that institutional investors recognize -- if only in their own interest -- that in computing the over-all cost of a securities transaction, the commission -- especially if you are operating in size -- is a much lesser factor than the price of the security in the market.

For example, on the purchase of 10,000 shares of a stock selling at 50 dollars -- a 500,000-dollar transaction -- the commission amounts to 2,960 dollars. This is the equivalent of less than 3/8 of a point in the market price of the stock. And it just does not make sense to shop

around for a bargain in commissions when the opportunity to shop is, itself, based on a less efficient market pricing system.

Our conviction at the NYSE -- as we have pointed out in great detail to the SEC -- is that a minimum commission structure is the best means of preserving a highly liquid market serving large numbers of buyers and sellers and, therefore, able to provide efficient pricing.

The details may be complex, but the basic concept is simple enough: Without the minimum commission, member firms would be encouraged to take their block business elsewhere, regulatory safeguards would be more difficult to support, ticker prices would be less meaningful -- and small and large investors alike would find themselves penalized by the decline in services and liquidity.

In line with our determination to improve -- rather than lessen -- liquidity, the New York Stock Exchange is developing a Block Automation System -- a computerized method of matching blocks in listed stocks. This will supplement existing trading procedures, facilitating our firms' efforts to serve institutional customers.

The system is expected to go into operation about year-end. Basically, here's how it will work. An institution wishing to sell, say, a 5000-share block will enter its interest into a central computer -- using a terminal device in its own or its broker's office. If another institution has entered a buying interest in the same stock, the computer will match the two, and the brokers identified by the two institutions will be notified to conduct discussion on behalf of their clients. Any resulting transaction will be consummated by the brokers on the floor of the Exchange in the same manner as block orders are now executed.

If the selling institution's interest is not matched, the offer will remain in the computer. The name of the security may be displayed -- at the discretion of the institution -- to other users

of the system. But to preserve anonymity, none of the specific details of the interest entered into the system will be displayed to other users.

We are about ready -- within the next week or so -- to begin discussions with individual institutions which we believe can derive the most benefit from participation in the Block Automation System. During the coming months, representatives of the Exchange's Institutional Investors Department will be calling on perhaps as many as 200 leading institutions. The purpose of these visits will be informational -- to acquaint prospective users with the basic capabilities and mechanics of the system. We believe we have a remarkably good service to offer, and these advance discussions will be helpful in clarifying operational details and answering questions about its usefulness to each potential subscriber.

As the actual start-up time draws nearer -- during the summer and fall -- follow-up visits will be made to institutions which may have expressed definite interest in participating. And at that time, we will be in a position to discuss prices, equipment and specific terms of agreement.

I cannot stress too strongly our conviction that there is no substitute, electronic or otherwise, for bringing securities to the central marketplace through a broker who is in touch with the full range of buying and selling interest in the market. This applies to trading in blocks as well as to individual purchases and sales. And it is one of the outstanding features of the NYSE's Block Automation System.

Before relinquishing the rostrum, I want to make one further point with reference to the use of the central market by the organizations which you (ladies and) gentlemen represent.

Mutual funds, as a group, are among the most active users of the market. During 1968, mutual funds bought and sold a total of nearly 39 billion dollars worth of common stock. This represents a purchase and sale rate of more than 45% of the market value of the funds' portfolios.

To the extent that this represents growth of public participation in funds, and the striving of funds for sound improvement in performance -- we welcome it. But it is no secret that not all the increased trading by all funds can be characterized that way.

While fund managers are, for the most part, using the market wisely and constructively, it is widely felt that there have been exceptions.

Funds have been accused of indulging in "excessive speculation" -- of taking risks with investors' funds which the individuals would not take on their own initiative. Critics have asked if activity in "thin" stocks, and competitive bidding among funds, are not unnecessarily risky devices to use in the race for spectacular performance. Again, I don't think anyone is really able to answer such questions on the basis of information that is currently available. To be sure, not many people will gain if these tactics ultimately weaken confidence in the market. And I would hope that one valuable service the SEC study may perform would be to develop some good criteria for judging what is and what is not "excessive speculation."

The success of the mutual fund industry to date cannot be divorced from the maintenance of a strong central auction market. It's not just coincidental that funds have grown and continue to grow at the same time that individual investing and market volume have grown and continue to grow. The one creates the conditions which makes the other possible.

Let me close, then, with this word for all institutions and all investors. The strength of the central auction market is essential to a strong securities industry, and to the strength of other elements in the larger financial community which buy and sell securities. Our chief interest is in maintaining efficient service to all investors -- however great or modest their activity in the market. And at the New York Stock Exchange, the emphasis these days is -- first -- to provide

that service to all who want it, and -- second -- to find the best means of maintaining and improving that service to all investors in the years ahead.

Thank you very much.