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NEW YORK / WASHINGTON / PHILADELPHIA / LOS ANGELES

**BROKERAGE RATES: COMPETITION OR REGULATION
AS THE PROTECTOR OF THE PUBLIC INTEREST?**

Irwin M. Stelzer

**President
National Economic Research Associates, Inc.**

**Before the
Securities Industry Association
Management Conference**

**New York, New York
September 20, 1974**

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IRWIN M. STELZER
PRESIDENT

September 26, 1974

Mr. James E. Buck
Secretary
New York Stock Exchange, Inc.
11 Wall Street
New York, New York 10005

Dear Mr. Buck:

As a member of the Board of Directors of the New York Stock Exchange, you might be interested in a talk I recently gave dealing with the question of fixed versus negotiated brokerage rates. It does call into serious question the SEC's decision to proceed with the latter in May of next year.

Sincerely,



IMS:gm
Enclosure
Signed in his absence

BROKERAGE RATES: COMPETITION OR REGULATION
AS THE PROTECTOR OF THE PUBLIC INTEREST?

Irwin M. Stelzer
President
National Economic Research Associates, Inc.

From the point of view of the Wall Street community, the entire long-drawn out controversy over fixed vs. so-called competitive rates has all the aspects of a tragedy: a tale "depicting a protagonist engaged in a morally significant struggle ending in ruin...."¹ But before those of you who are members of that community take too much delight in the moral significance of your struggle, let me point out that the dictionary goes on to state that the "noble protagonist is brought to ruin essentially as a consequence of some extreme quality which is both his greatness and his downfall."²

To carry the analogy to tragedy one final step, I think we can better understand the unfolding drama if we examine the cast of characters.

The self-proclaimed star of the show is, of course, The New York Stock Exchange. This venerable character for many years survived and prospered by a combination of good economic performance and resistance to outside interference

¹ *The American Heritage Dictionary of the English Language*, s.v. "tragedy."

² *Ibid.*

In the good old times...brokers throve mightily, and grew passing rich simply upon their commissions.

JAMES K. MEDBERY
Men and Mysteries
of Wall Street, 1878

which were equal wonders to behold. So great was the success of this star that the price of seats for the show rose steadily, capitalizing the increasing economic rents which he was able to charge for admission.

Playing what some claimed was an excessively supporting role was the Securities and Exchange Commission. Charged with reviewing the performance of the star, it tended often to be so beguiled by that performance that it became instead a cheerleader, reluctant to press for cast replacements indicated by age, or the modernization of the theater that new technology came to permit.

In an apparent effort to goad the reviewer, a new critic appeared, the Department of Justice. Filing its reviews for the underground press, it sniped at the play, the cast and even the other reviewer. It suggested that the book be changed, that new rules be adopted, that the play be staged everywhere simultaneously, that admission fees be eliminated, and that an unstructured improvisation called "competition" replace the carefully drawn script which had been used and re-used by our star for years.

What emerged, then, was a battle of interested parties, and one in which the audience--the public whose interest was to be served--was simply forgotten. Let me explain.

The Exchange, particularly as it was structured during the height of the controversy, had as its goal the

maximization of members' profits. There is nothing wrong with this, so long as one doesn't first attempt to break "the invisible hand" which is supposed to lead profit-seekers to behave in the public interest, whether they care to or not. In other words, the industry preferred a situation in which the only limit on its avarice would be self-imposed:³ competition was rejected as a profit-limiting device, as was any form of regulatory review of cost and profit levels. While embracing the notion that competition could not work in the brokerage industry, Exchange members rejected its replacement by regulation. So one party to the dispute had as its goal unconstrained, collusive price-fixing, tempered only by such regulatory oversight as was minimally necessary.⁴

Another party to the dispute was the SEC, historically one of the great regulatory agencies, long known for the vigor and intelligence of its programs to see to it that investors received a fair deal. But the brokerage rate problem proved to be a different kind of problem from any faced

³ This would, it was early felt, be sufficient protection. "One of the finest characteristics of brokers is their generosity. There are few mean men in and around Broad and Wall Streets." James K. Medbery, *Men and Mysteries of Wall Street* (New York: R. Worthington, 1878; reprint ed., University Microfilms, 1968), p. 139.

⁴ "And when we look at ourselves,...we see an industry that historically has given the appearance of being self-serving, and one which has appeared to have been kept in check only by government intervention." James J. Needham, "A Blueprint for Securities Markets of the Future," Address at the annual meeting of the Securities Industry Association, December 1, 1972, p. 1.

by the Commission. It was one which did not lend itself to such tried-and-true SEC tools as full disclosure, dissolution and reorganization of corporate structures. Rather, it involved a kind of economic problem which the SEC had not addressed: how should prices be set in an industry with certain very special characteristics? Of overriding concern to the SEC was its historic reputation as a superior agency--a reputation it attributed in good part to the fact that, unlike the Federal Power Commission and Interstate Commerce Commission, it was not a *rate* regulatory agency. So, like The Exchange, the SEC had a vested interest to protect, in this case, its good name. Since nothing seemed more threatening than the imposition of a formal rate review function, and since the historic procedures were clearly decreasingly appropriate to the increasingly complex circumstances of the industry, the SEC developed a bias--an understandable one--in favor of competitive rates.

The Department of Justice also had an interest to protect: the need in situations like this for *someone* to speak up on behalf of competition. Consequently, in April of 1968 the Department filed a brief commenting on SEC Release No. 8239⁵ and recommending as follows:⁶

⁵ Comments of the United States Department of Justice, "Inquiry into Proposals to Modify the Commission Rate Structure of the New York Stock Exchange, SEC Release No. 8239," April 1, 1968.

⁶ *Ibid.*, p. 6.

The Commission should promptly take appropriate steps to determine the extent to which commission rate fixing by the NYSE is required by the purposes of the Securities Exchange Act. The Commission should then take action (a) to eliminate all rate fixing which is not found to be justified in the public interest; (b) to develop and promulgate standards governing the validity or reasonableness of any commission rates for which rate fixing is permitted to continue; and (c) to determine the proper means for assuring equitable and nondiscriminatory access by non-member broker-dealers to the NYSE market.

In support of its position the Justice Department marshalled an impressive list of economists, all of whom presented somewhat less impressive testimony generally stating the strong preference all economists share for market determination of prices for goods and services. This preference is based on the realization that properly operating competitive markets are the most satisfactory mechanisms for the efficient allocation of resources. So there is no question that it was important that the Justice Department's pro-competition assumption be put before The Exchange and the SEC: who else will speak for competition if the Antitrust Division does not? But at that point one of two things can happen: Justice can stop at the point of raising a rebuttable presumption, or it can go on to the hard task of analyzing the specific economic facts of the brokerage industry to decide whether regulation-- as I shall later define it--or competition can best serve the public interest. Unfortunately, it chose to stop at the presumption-raising level, and there unfolded an eerie scenario in which the contending parties were much like Longfellow's

"ships that pass in the night."⁷ That scenario--a not uncommon one these days--goes generally as follows: Some party opposed to regulation--oil producers in the case of Federal Power Commission regulation of natural gas prices, the Department of Justice in the case of commission rates--will present one or more well-known academic economists to explain the virtues of competition. Such testimony is, as a rule, cast in rather general and theoretical terms. Those favoring regulation--consumer groups in the case of natural gas, The Exchange in the case of commission rates--respond with detailed analyses of the structure and performance of the industry in question to demonstrate that competitive market determination of prices will result in unsatisfactory performance, and that pricing decisions should therefore be removed from the marketplace and placed under some regulatory scheme.

What is most troublesome is the failure of these contending parties ever to meet. In the case of commission rates, for example, Dr. Freund, of The Exchange, never denied--in his excellent paper,⁸ and one which bears rereading--the general desirability of competition; and Professor Baumol and other leading academic economists never addressed themselves to the question of whether the economist's preferred form of

⁷ Indeed, those ships at least "speak each other in passing"; unfortunately, "Only a look and a voice; then darkness again and a silence."

⁸ The New York Stock Exchange, "Economic Effects of Negotiated Commission Rates on the Brokerage Industry, the Market for Corporate Securities, and the Investing Public," August 1968.

industrial organization would work in the special fact situation of the securities business. This occurs, in my judgment, primarily because there is some tendency to believe that a showing that an industry has a competitive structure--many sellers, none dominant--is generally considered sufficient proof that competition will work. But, as one observer has noted, "the case for regulation is that the market, free of governmental control, may produce undesirable results whether because it is ineffectively competitive or because the presence or absence of competition is not in itself and in all situations a complete and sufficient test of whether or not government intervention is required."⁹ An industry may indeed have "...unique characteristics that give rise to unique kinds of behavior and unique consequences. And these unique characteristics are perfectly legitimate subjects for regulatory concern."¹⁰

The Public Interest

Before turning to the allegedly "unique characteristics" of the brokerage industry, let us pause for one moment

⁹ Testimony of Alfred E. Kahn in Champlin Oil & Refining Co., Federal Power Commission, Docket Nos. 9277, *et al.*, March 26, 1959, p. 4881 LC.

¹⁰ *Ibid.* Kahn, of course, does not support fixed brokerage rates, apparently preferring competitive rates to self-regulation, with "effectively regulated rates" his second choice. *The Economics of Regulation: Principles and Institutions* (New York: John Wiley & Sons, Inc., 1971), Vol. II, pp. 193-209.

to reflect on wherein the public interest lies, for it often becomes lost in the battle of the contending parties. In my view, the public has two concerns:

1. Brokerage services should be available at the minimum cost consistent with the maintenance of capacity adequate to permit the brokerage industry to meet its obligation to serve.¹¹

2. Capital markets should function in a manner which will permit the raising of the enormous quantities of capital required by American industry in the next decade,¹² at minimum cost. This means that the underwriting segment of the industry must be viable, and must have available to it a distribution network through which to market securities.

Characteristics of the Industry

Let us now briefly examine the nature of the "unique characteristics" of the securities industry, so that we can have some sense of the precise nature of the hard factual questions which must be explored in a controversy of this type.¹³

¹¹ If anyone thinks no such obligation exists, let him recall public and SEC reaction to the so-called "paperwork crisis," during which the industry was temporarily unable to meet peak demands instantaneously.

¹² The Exchange estimates that capital demands through 1985 will total \$4.7 trillion. See its *The Capital Needs and Savings Potential of the U.S. Economy*, September 1974.

¹³ For a similar discussion in other industries (air transport, trucking, telecommunications, natural gas), see Kahn, *op. cit.*; Daniel Marx, Jr., *International Shipping Cartels*;

For purposes of exposition I shall set these forth as they are alleged to exist by The Exchange, partly because Dr. Freund's 1968 paper remains the only systematic attempt at their analysis. I hasten to note that I do not consider any of these positions yet proven, nor even adequately explored, particularly in relation to the public interest questions I have raised.

1. The total demand for securities is relatively inelastic,¹⁴ so that changes in commission rates will not significantly alter the demand for stocks. But the demand for a given firm's services is highly sensitive to the level of its prices relative to those charged by its rivals.
2. For brokerage firms, there is a substantial gap between the marginal cost of executing one additional transaction and the average cost of all transactions, with the result that intense price competition will follow any weakening in demand. Member firms would suffer large losses since the industry's fixed costs constitute a high proportion of its total costs. The nature of this competition would be particularly destructive in the sense that it would eliminate even highly efficient firms, while sheltering some which are inefficient. It would, thus, not accomplish any purpose in the public interest.

¹³ -continued-

A Study in Industrial Self-Regulation by Shipping Conferences (Princeton: Princeton University Press, 1953), esp. pp. 293, 300; and Jesse W. Markham, *The Fertilizer Industry: Study of an Imperfect Market* (Nashville: Vanderbilt University Press, 1958), esp. pp. 207-208.

¹⁴ According to Kahn, this "seems likely," *op. cit.*, p. 208; although Chairman Needham's reported statement (*The Wall Street Journal*, September 17, 1974, p. 8) that the volume of trading by small customers was, in aggregate, sensitive to rates would seem to provide contradictory evidence.

3. Sharp fluctuations in demand for brokerage services require that excess capacity be maintained in times of "normal" volume, since brokerage firms must be able to provide prompt service during periods of peak volume.

The *evidence* required to support or refute each of these points is necessarily voluminous. Questions of demand elasticity and cost characteristics are subject to empirical study, often of a highly refined and technical nature. This necessarily makes for long and complex hearings, something which troubles many critics of the regulatory process somewhat more than it does those of us with (a) more patience and interest in due process, or (b) a direct stake in long hearings--choose your motive.

It is my own view that the weight of the evidence adduced supported those who argued that the result of across-the-board competitive ratemaking is likely to be undesirable. While my reasons differ in part from those of The Exchange, the conclusion I reach is similar. Basically, if we are to maintain an auction market mechanism which permits almost instant liquidity, and consequently probably lowers the cost of equity capital in the United States, we must somehow maintain capacity to meet enormous peaks in demand for brokerage services. (This problem is not, by the way, unique to the brokerage industry.) There are really only two ways to do this. One would be to allow competition to cause rate fluctuations which would, in turn, lead to periodic creation

and destruction of capacity.¹⁵ The other is to fix rates high enough so that it becomes economic for firms to maintain some excess capacity in slack periods. Note that this excess capacity, which must be preserved if peak demands are to be met, is not the long-run inefficient capacity which troubles the Antitrust Division¹⁶ and which economists uniformly agree should be eliminated from an industry by price-cutting and the competitive catharsis resulting therefrom.

This does *not* mean, of course, that regulated rates must be combined with all of the present institutional arrangements associated therewith. For example, regulation combined with some "unbundling" so that customers can select the service mix most in line with their needs must be carefully considered--and by "considered" I don't mean studied at the glacial pace historically preferred by The Exchange. So, too, must the possibility that the ratemaking mechanism appropriate to the retail market might be different from that appropriate to transactions in very large blocks. The underlying point which must be kept in mind is that the method of price making selected should be that which over time yields the lowest average cost to the customer. And I submit that

¹⁵ This is the essence of the Antitrust Division's suggestion for meeting the peak-load problem. See *Securities Week*, July 8, 1974, p. 4, for a report of the Division's views.

¹⁶ "Memorandum of the U.S. Department of Justice on the Fixed Minimum Commission Rate Structure," January 17, 1969, p. 110. (Hereinafter, Memorandum.)

this type of choice is both more relevant and more difficult than one between two abstractions: "competition" and "regulation."

The Argument Against Regulation

The other aspects of the "regulation" vs. "competition" argument in the securities business relate really to certain fundamental fears of the stultifying effect of the regulatory process on innovation and other aspects of economic performance. I believe it is worth reviewing this aspect of the controversy, too, as it has general applicability to other industries. In so doing, the most efficient procedure would be to list and comment on the objections raised by various parties to regulation:

1. Regulation produces "universal mediocrity"¹⁷ and confines itself to "static, backward-looking" criteria.¹⁸ This contention stems from a general fear that regulation, typically on a cost-of-service-plus-fair-rate-of-return basis, is inherently devoid of any consideration of the adequacy of the economic performance of the regulated company or industry. This is simply incorrect. Regulatory commissions have shown an increased tendency to emphasize two important aspects of performance: quality of service and efficiency. As to the

¹⁷ Testimony of William J. Baumol, *In the Matter of S.E.C. Rate Structure Investigation of National Securities Exchanges*, File No. 4-144, Tr. 3656.

¹⁸ Memorandum, p. 164.

former, commissions have begun to deny inflation-induced requests for rate relief if the petitioner has a record of inadequate service.

The second aspect of performance which is being given some consideration is efficiency. To some extent, the fact that we are here considering group regulation automatically reduces our concern with this problem, for reasons I will note in a moment. Furthermore, while the trend here is not nearly so clear as it is in the case of service quality, it is nevertheless apparent that regulators can tackle this problem. In New York, for example, the Public Service Commission has ordered an intensive study of Consolidated Edison's efficiency, and has begun an inquiry into the quality of facilities planning by companies subject to its jurisdiction.

The point of these examples is to demonstrate that regulators are aware of, and capable of responding to, the need to do more than allow regulated companies to operate in a lazy, inefficient manner. And if state regulatory agencies can inject performance standards into their rate reviews, I see no necessary reason to believe that the SEC will follow a less enlightened and dynamic path.

2. There are "special difficulties of rate regulation in the brokerage field":¹⁹ The Department of Justice

¹⁹ Memorandum, p. 13.

feels that regulation of commission rates would be made difficult "by the multiplicity of firms, the great variations in their costs, and the absence of regulatory control over entry, exit, and many aspects of [a] firm's operation."²⁰

What this recital ignores is the prospect that rate regulation on a group basis avoids the very potential regulatory difficulties and inefficiencies which the critics of regulation, including the Justice Department, find inherent in the regulatory process. Even if we ignore recent regulatory experience, and accept the view that "rate regulation cannot compel either cost efficiency or innovation,"²¹ it should be clear that that problem attenuates with the adoption of group regulation along the lines which have been proposed to test the reasonableness of commission rates. As I will discuss shortly, the SEC would be regulating the brokerage industry on a group basis, allowing the industry in aggregate to recoup its costs, but refusing to concern itself with the ability of individual firms to do so. Such a method of rate determination, applied to all firms but guaranteeing no one of them any specified rate of profit, would provide an incentive for efficiency, prudence in the incurrence of cost, and inducement for cost-reducing

²⁰ *Ibid.*, p. 166.

²¹ *Ibid.*, p. 163.

innovation. A firm would have an opportunity to outperform others and exceed the average profitability level set for the industry and would run the risk of falling below it. The feared need for detailed regulation of individual company operations would not materialize. A firm's individual response to the industry-wide rate structure, as well as individual company profitability, would be left to the results of competition.

Note that under this approach a great many firms would have profitability levels well below the industry average--precisely the situation which would exist in a free market. Just as the market guarantees no *one* firm a profit, the commission rate structure would guarantee no NYSE member a profit. The SEC would *not* have to do what some of its staff members feared: "determine which firm or firms are to receive that [desirable] return and which are to receive higher and lower returns."²² That result would be determined by business rivalry.²³

²² Testimony of Bernard Garil, SEC File No. 4-144, Tr. 4254.

²³ Other regulatory bodies have found group regulation to have precisely these advantages. The Civil Aeronautics Board sets passenger fares on a group basis, and recognizes "the risk that, because of competitive disadvantages, an individual carrier will be unable to earn the weighted average return found reasonable." (32 CAB 305 [1960].) In fact, the CAB interpreted a statutory mandate that it consider the financial needs of "each" carrier in a manner which permitted it to reject the contention that fares be based on the results of the most poorly situated carrier.

-continued-

3. It is impossible to regulate multi-product firms: Another difficulty raised by the Department of Justice relates to the multi-product nature of most brokerage firms. This would, in the view of the Justice Department, create "difficulty in determining the cost of the brokerage service with which the rate would be associated since brokerage firms (unlike many traditional regulated monopolists) are often multi-product firms, with extensive other activities not subject to rate regulation."²⁴ First, it is an error to state that brokerage firms are, in this regard, "unlike many traditional regulated monopolists...."²⁵ Many natural gas pipelines have wide-ranging interests in unregulated enterprises; distribution companies often serve both gas and electric, and to a variety of customer classes; railroads have interests ranging from real estate to oil; producers of natural gas also produce crude oil, own gasoline stations and real estate, and prospect for uranium. These situations often confront the regulator with difficult

²³ -continued-

(*Ibid.*, pp. 329-330.) The Justice Department suggestion (Memorandum, p. 166) that multi-firm regulation is unique and would make the SEC "unlike the typical regulatory agency" is simply wrong. The Supreme Court has noted that "regulation by group or class was a recognized administrative method even in 1937." *Permian Basin Area Rate Cases*, 390 U.S. 747, 774 (1968).

²⁴ Memorandum, p. 166.

²⁵ *Ibid.*

questions of cost allocation, and in the case of the SEC will indeed, as the Department of Justice notes, confront it with "the necessity of defining capital in securities firms, and segregating that part of firm capital which was devoted to brokerage services as opposed to other activities...."²⁶ But if the difficulty of a task in the course of the regulation of business activity necessarily resulted in its abandonment, the antitrust agencies would long ago have thrown up their hands at problems of market share determination, line of commerce definition, and ascertainment of "intent."

Second, the multi-product nature of most firms does not, as Justice suggests, cause a problem by making difficult "effective control over the overall return of exchange members...."²⁷ So long as commission rates in aggregate yield a reasonable profit on *that* aspect of the industry's activities, the SEC need not concern itself for these purposes with "overall return of exchange members." Losses in other activities will not be recouped out of higher commission rates, and high profits in unrelated endeavors cannot provide a proper basis for lowering commission rates. Admittedly, problems of allocation of capital will exist;

²⁶ *Ibid.*, pp. 167-168.

²⁷ *Ibid.*, p. 41.

indeed, The Exchange persists in arguing that it cannot allocate costs to the brokerage segment of the industry. But this inability will presumably be overcome as The Exchange rediscovers its position in favor of fixed rates. Of course, any newly-discovered allocative powers will call into question the entire exercise through which The Exchange now goes to justify its rate increases by reference to *overall* profit and loss data for member firms.

One final point should be kept in mind in appraising these issues. The goal of all contenders appears to be identical: brokerage rates related to costs. The competition school would accomplish this through the market mechanism; those who fear the results of that process would do so via regulation.

The Form of Regulation

In the fixed-versus-competitive-commission debate it is important to keep in mind the *form* regulation might take; no one is seriously suggesting, any longer, a return to the private club method of ratemaking which allegedly²⁸ prevailed before the SEC and the Justice Department called a halt to it. In lawyer's parlance, we can reject, at the outset, the notion that *ad hoc* determination of rates by

²⁸ The "allegedly" is in recognition of the dispute which exists over the character and effectiveness of early regulation, an issue which I have not studied sufficiently to have a considered judgment.

SEC-NYSE negotiation constitutes an acceptable manner to meet the statutory criterion of "reasonableness."

To anticipate, the basic approach which constitutes the alternative to the competitive determination of appropriate commission rates is that the rate level and structure be closely regulated, and be set in relation to costs.²⁹ This approach would be followed in determining the reasonableness of the *level* of rates--i.e., the appropriate aggregate amount of commission revenues--and in appraising the *structure* of rates--i.e., the specific rates to be charged for different transactions. In what follows I shall first discuss the rationale for basing rate *levels* on financial requirements and then discuss the rationale for appraising the rate *structure* by testing it against a cost-related standard.

1. Cost-Related Rate Levels

There are several conceivable approaches to determining whether a given price is reasonable or not. One is to see whether the value of the service rendered is "worth" the price paid for it. But obviously any sale which is completed must be worth at least as much to the buyer as the price he was willing to pay. Hence, no monopolist

²⁹ Throughout this discussion, the term "costs" should be understood to include a reasonable return on invested capital. And a rate structure "related to" costs should not be misunderstood to mean rates "equal to" costs.

could ever collect an unreasonable price on this peculiar definition of reasonableness.

A second approach is to try to show that prices that have been, or would have been, arrived at *via* the competitive process are reasonable. This is generally true in the long run, although it may not be true of industries subject to destructive competition. But how, in the enforced absence of price competition, can we determine what prices *would have been* arrived at in its presence? The answer which economic theory provides is that under competition prices will be directly related to "costs" both in the long run and in the short run.³⁰ But the precise result which would be arrived at under a competitive regime cannot be simulated for any given industry, since the long-term process by which prices are brought into equality with costs may entail restructuring of the industry and of its cost patterns. For all practical purposes, therefore, the theoretical ideal of the competitive result cannot be duplicated by simulative models.

A third approach is to aver that prices are reasonable if they bring supply and demand into equality. A more sophisticated version is that prices should be adequate

³⁰ To simplify greatly, in the short run, prices will be equal to short-run *incremental* costs; in the long run, prices will be equal to long-run incremental costs, which will be equal to long-run average costs except in the continued presence of economies of scale.

to elicit just the right amount of supply. Analysis of this approach shows that, to the extent it is at all meaningful, it boils down to reliance on costs. First, the optimum quantity to be supplied depends on whether the *cost* of providing additional supply is greater than the value of that supply. Second, the price which will bring forth desired supplies will be that price which suffices to meet costs and provides a reasonable return. Thus, the "adequate supply" approach tends to reduce to a cost approach. This is not to say that consideration of supply and demand factors is without any usefulness. In circumstances where supply adequate to meet demand at existing prices is not forthcoming, we may conclude that prices are not high enough relative to costs-- a conclusion which should, however, be supplemented by a more direct study of costs. (The reverse case, in which supply is excessive, is more difficult to detect.)

Finally, we come to cost-related rates. There are several major advantages to this basis for setting rate levels. First, the public is assured that the member firms are not earning any monopoly profits, and that their profits are at a reasonable level compared to those in other industries. Second, unless regulatory lag develops into a severe problem, the brokerage industry is assured that rates will not be depressed to a level such that the industry cannot expect to recover its costs and earn a reasonable return on the capital it has invested to serve the public. Third,

with rates set at a level just adequate to cover the industry's costs and yield a reasonable return, there is at least a very strong presumption that adequate but not excessive resources will be devoted to providing the public with the services it desires.

2. Cost-Related Rate Structure

A rate structure may be improper from the standpoint either of equity or of efficiency. A reasonable rate structure is one which will not unfairly or inequitably³¹ discriminate against particular customers or suppliers. It is also a rate structure which will not lead to an inefficient allocation of resources.

An industry-wide rate structure should be equitable both as it affects different customers and different firms. As among customers, it is clearly a desirable goal that no customer be charged more than another for the performance of services which are no costlier.³² No customer can have cause for complaint if the charges to him are the same as the costs of serving him. Indeed, since the *aggregate* level of revenues is to be determined by costs, a rate structure under which one customer is charged less than the cost of serving

³¹ It should be remembered that equity is not necessarily the same as equality; equitable rates are not necessarily equal rates.

³² This test of fairness is embodied in the Robinson-Patman Act which forbids price discrimination in the absence of cost differences.

him will necessitate charging some other customer more than the cost of serving him. Where the interests of customers are interrelated, as is the case in the securities industries (large investors require the steady flow of small orders to provide security price guides), such subsidization may be appropriate. But it is important to be aware that it is occurring, and to make that subsidization a conscious act of ratemaking policy.

By the same token, the rate structure should not discriminate among firms doing different types of business. Rates should bear the same average relationship to costs for large orders as for small orders, for institutional business as for retail business,³³ for round lots as for odd lots, etc. If this is done, then firms specializing in one type of business will have the same profit opportunities as firms specializing in other types of business.

The discussion thus far has been couched in terms of equitable treatment of different firms and different customers. But this does not mean that different rates should be charged according to the type of customer served

³³ Compare this desideratum with the result of so-called competitive rates, when some firms increased rates 5 percent "only on individual accounts, not institutions." *Securities Week*, July 8, 1974, p. 3. Others compounded the discrimination by "giving salesmen and traders leeway to back off the increases if institutions balk." *Securities Week*, July 15, 1974, p. 4. There is no report of an antitrust action being brought to prevent this discrimination, a type no responsible regulator would permit. The discrimination against small retail customers eventually became all-pervasive. *Securities Week*, July 22, 1974, p. 1.

or the type of firm rendering the service. Rather, rates should be related only to the characteristics of the order, without regard to the identity of either the customer or the broker--rates which, for each type of order, will correspond to the industry's cost experience in handling orders of that type. Thus, there will be no discrimination for or against customers (or firms) of different types based solely on *who* they are rather than on what they do.

Rate structures should meet the test of efficiency as well as the test of equity. There are two aspects of efficiency to be considered. First, the rates should induce the brokerage industry to allocate its resources appropriately so as to provide the various services required of it. More concretely, the rate structure should not lead to the sort of situation in which many firms try to avoid or refuse services on small orders.

Second, the rate structure should not distort the pattern of trading in an uneconomic manner. This means that the market should be orderly, that customers' orders should be executed reasonably promptly at favorable prices and in the least costly manner. It also means that there should be no *artificial* channeling of investors' capital in any particular direction such as to high-priced or low-priced stocks, concentrated or diversified holdings, etc.--but that only economic considerations (cost and efficiency) should prevail. Moreover, trading should not be diverted away from

the central auction market by rates which are either too high or too low relative to costs.³⁴

If regulation is the chosen route, these goals of efficiency would be best served by adopting cost as a standard of reasonableness in regulating rates. Where rates deviate from costs, the services involved are either excessively, or insufficiently, profitable. Insufficient profits tend to divert capital and other resources away from lines of activity where the value of the output would really be greater than the cost of the resources required to produce it. Excessive profits will, of course, have the precisely opposite result; moreover, they can lead to economic distortions as a result of activity aimed at distributing the excess profit. Thus, were it possible to determine costs with precision, and feasible to ignore market, political and other relevant factors by setting rates equal to costs, the correct amount of resources would be attracted and properly remunerated.

Conclusion

I have thus far avoided coming down on one side or the other of the current debate, although I do have a

³⁴ It should be noted that in some instances it might be desirable to attract trading to the central market by rates which may deviate from costs, on the ground that the resultant improvement in the liquidity and depth of the central market will benefit all investors.

leaning derived from my weighing of the quality of the argumentation on both sides. I would like to conclude by offering these observations.

1. There seems to be no end to the willingness of the parties to this dispute to adopt positions without studying them. It serves no purpose for a regulator to cite the inability of the industry to make a rate increase stick as indicating a lack of need,³⁵ when the very issue is whether or not there is destructive competition. Nor is it useful for the industry to poll and repoll itself to establish that it favors being permitted to charge fixed rates to the public,³⁶ while at the same time polling itself to establish the opposition of an important segment of the industry to paying fixed rates for the floor brokerage services it buys.³⁷ What is required is hard information on the costs and benefits of various approaches to the industry's problems, not a continual guessing game as to what each other thinks about this or that issue on a given day.

³⁵ *Securities Week*, August 19, 1974, p. 1.

³⁶ "Three-quarters of Brokers in WSL Poll Favor Staying With Fixed Rates After 'Mayday.'" *Wall Street Letter*, Vol. IV, No. 34, August 26, 1974, p. 1. See, also, *The Wall Street Journal*, September 17, 1974, p. 8.

³⁷ *Securities Week*, July 8, 1974, p. 6. In this connection, note Chairman Needham's admonition: "We see an industry so torn by internal dissension and self-interest that it has become fractionalized...." *Loc. cit.*

2. If there remains at the SEC a willingness to listen, the public interest demands that the issue of competitive vs. fixed rates be reheard in light of (a) industry experience with partially competitive rates and (b) current and prospective pressures on capital markets. Such a hearing should go far beyond a statement of positions. And it should not suffer from the procedural flaws of the last round of so-called investigatory proceedings. Because those proceedings were technically investigatory rather than adversary in nature, the decision-making process became one in which the SEC Staff prepared a summary of the record and recommendations, which it then submitted to the full Commission. No party saw or was permitted to comment on this document. If it contained errors which importantly influenced the Commission's judgment, they were never corrected--and the complexity of the issues combined with the length of the record to make such errors quite possible regardless of the competence of the persons involved. So cast my vote for overtly adversary proceedings with all their safeguards.

3. If The Exchange is indeed serious in now favoring regulated rates, it will have embarked upon a road which has many implications of which its members should be quite aware. Let me mention three of these:

a. Regulation on a cost-related basis ultimately includes some consideration of the prudence of the costs incurred by member firms. This is less crucial in

group than in company-by-company regulation, since the former preserves individual firm incentive to profit maximize. But it is inevitable that questions of the reasonableness of the level of registered representatives' compensation, the number of branch offices, etc. will be raised.

b. Regulation of the type I have described will ultimately involve a resolution of the so-called "unbundling" question. At present, the commission rate covers a variety of services, ranging from execution of an order through research activities. The propriety of this procedure--the feasibility of separately costing and separately charging for services which not all customers may desire--will have to be reviewed and, most probably, decided in favor of unbundling of some sort.

4. The practical problem of reconciling economically appropriate regulation with political realities is a most difficult one. For example, even if cost studies show that increases of major magnitude are indicated in rates for some small orders, approval for those increases is often difficult to obtain. Aside from the demand-elasticity considerations which might support such a decision (also, the flow of small orders provides the continuous pricing mechanism on which larger customers rely, making below-cost rates not necessarily inappropriate here), political considerations are involved. Congressional committees share with regulatory agencies a concern for "the small investor," and are loathe

to increase his rates "disproportionately." This factor, of course, pervades all regulation. Personally, I find it not wholly inappropriate--for two reasons:

a. Sharp, one-step changes in rates seem to me undesirable. The person who has bought stock has done so with some expectation that the cost of selling it will not have doubled within a short period. So refusals to raise rates by large amounts for any customer group has something to be said for it.

b. The large buyer--of brokerage services, electricity, gas--often has substantial economic power, stemming from his ability to exercise market alternatives. So the regulated company is careful not to "overcharge" him. The small customers lack such economic power--but have the political power inherent in their numbers. This causes regulators to lean over backwards in *their* favor. This offsetting distribution of economic and political power may help produce more equitable rate structures than would otherwise prevail.

5. The role played by the Department of Justice was an extraordinarily useful one, from the point of view of the public interest. The Department forced the SEC and the NYSE to consider more or less explicitly certain issues which might otherwise never have been carefully scrutinized. This comment is not intended to be in any way critical of the SEC: regulatory agencies have characteristically

proceeded without explicitly considering the role which might be assigned to competition in the scheme of things. Of late, the Antitrust Division has begun to force such consideration on the SEC in this and other matters (e.g., electric utility mergers), and on the FPC, CAB and FCC--a healthy development.

What is needed? Facts.

First, we need some analysis of the effect of recent experience with competitive rates. Can such experience tell us anything at all about the long-run effect of competitive rates in all portions of the industry's rate schedule? If the answer is "yes," what does that experience have to teach? Is the demand of small investors for the industry's service responsive to rates? How responsive? If not responsive, is that demand nevertheless highly elastic with respect to an individual firm's rates? If so, is there indeed a combination of industry and firm elasticities tending toward destructive competition? Similar questions can be raised in the case of institutional buyers of brokerage services; when Merrill raised rates institutional buyers indicated their belief that the services rendered by Merrill were sufficiently undifferentiated from those of other brokers to make demand almost perfectly elastic.³⁸

³⁸ Sample reactions from institutions: "In most transactions there are other people who can do just as good a job"; "I have great respect for them, and I know
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And does the decline in seat prices mean that the age of monopoly profits is, in any event, at an end?

Second, we need some close study of the probable effect of competitive rate setting. What will the structure of the industry probably be like? Will a few firms indeed dominate the brokerage business? If so, and if back-room market making replaces the central auction market, what plans do the SEC and Antitrust Division have to ensure fair dealing? To prevent discrimination? Will these firms tend to transfer any acquired dominance to the underwriting business, creating a bottleneck through which their capital-raising clients will have to squeeze?

Third, we need close study of the feasibility and administrative costs of the regulation alternative. Was my firm correct, many years ago, in its proposal for allocating costs among the various segments of the member firms' business? Or is that job, as was then alleged, simply impossible to do? Can the SEC be given the rate regulation function without impairing its effectiveness in other areas?

Finally, a review of The Exchange itself is indicated. Has it recognized its unique public responsibilities to the extent that it should? It appears to have come a

³⁸ -continued-

they need the higher commissions, but starting Monday I'm not going to use them....[I]n most cases we can get as good execution and other services elsewhere." *Securities Week*, July 1, 1974, p. 4.

long way, at least on paper. But is it indeed disciplining poorly-performing specialists? Why are specialists' ratings not published, the bottom 50 percent or 75 percent denied new stocks, and the bottom 25 percent put on notice to "shape-up-or-ship-out"?³³ Are member firms, large as well as small, being judged by the same standards when reviewed by The Exchange in one connection or another?

I recognize that these are difficult questions, that assertion is easier than study, and that the easiest thing of all would be to grant the wishes of those coequal titans, the Department of Justice, the SEC and Merrill, and proceed to Mayday. Of the three, the latter probably has the most accurate prediction of the result of such a non-policy.

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I trust I have not covered too much material too quickly. To those of you interested in pursuing this matter in greater depth I recommend a reading of the transcript of all the SEC and congressional proceedings, soon to appear under the title "The Making of a Rate Structure: 1970-1974."

³³ In this connection, see the interesting questions raised by Donald Weeden in his statement opposing continued fixed floor brokerage rates. *Securities Week*, July 15, 1974, p. 8.