STATEMENT BY DR. WILLIAM C. FREUND, VICE PRESIDENT AND CHIEF ECONOMIST, THE NEW YORK STOCK EXCHANGE, INC., BEFORE THE SECURITIES AND EXCHANGE COMMISSION, SEPTEMBER 24, 1974

It scarcely seems necessary today in Washington to comment on the devastating impact of intense and widespread inflation on the national economy. The current round of unprecedented top-level economic conferences has focused worldwide attention on the gathering effort to bring U.S. inflation under control.

Our concern at these hearings is the impact of over-all national cost trends on the securities industry -- as exemplified by the New York Stock Exchange's finding that the rate of inflation applicable to brokerage costs has been 9.2% since June 1973, the last month of inflation reflected in the commission rate adjustment that became effective last fall.

The purchasing power of the dollar has been declining at an annual rate of more than 12%, as measured by the GNP implicit price deflator, and aggregate inflation has involved far more than escalating prices for foods and fuel.

For example, from July 1973 to July 1974, the Consumer Price Index rose 11.8%. Excluding food, the rise was still 11%. From August 1973 to August 1974, the Wholesale Price Index rose 17.3%. If fuel and power costs had not risen <u>at all</u>, the increase still would have been 16.8% -- a difference of only one-half of one percent.

The accelerating increase in prices has been pervasive. In the 12 months ending January 1974, consumer prices rose 6.7%; in

the 12 months ending February 1974, the increase was 7.0%. And the figures for subsequent months were: March, 7.6%; April, 8.0%; May, 8.7%; June, 9.3%; and July, 10.2%. If food is excluded, the pattern remains the same, with 12-month increases of 6.1%, 6.9%, 7.9%, 8.6%, 9.7%, 10.6% and 11.8%.

Nor does the recently released Wholesale Price Index for July offer much in the way of encouragement. Indeed, the 3.9% increase in August -- which translates into an incredible annual rate of 58% -- makes it clear that double-digit inflation has become a stubborn feature of our national economy.

As Chairman Needham noted in his opening statement, the specific rate proposal we are now presenting differs in one major respect from the proposal submitted to the Commission earlier this month. In our detailed report, "The Crisis Of Member Firm Profitability And The Need For A Securities Commission Rate Increase," we urged a 7% rate increase on the fixed portion of orders between $2,000 and $300,000. Our amended proposal calls for an 8% increase on orders above $5,000, with no change on orders between $2,000 and $5,000. A detailed explanation of the modified rate proposal can be found in our document entitled, "Addendum To "The Crisis Of Member Firm Profitability And The Need For A Securities Commission Rate Increase": Revision Of Specific Rate Proposal."

However, the effect of this change would simply be to preserve the ongoing rate experiment with smaller orders and to give the majority of individual investors the opportunity to select a broker entirely on the basis of commission-rate considerations.

The justification for the amended proposal is essentially the same as that for the initial proposal. We do have some additional supporting evidence for the amended proposal, however, which I would like to submit for the hearing record at this time. In addition, since the preparation of our detailed report, some new figures have become available. In the month of July, New York Stock Exchange member organizations recorded additional losses aggregating more than $17 million -- with 58% of the firms in the red -- bringing the over-all industry loss for the first seven months of 1974 to approximately $75 million. Although the August figures are not yet in, there is no reason to expect any reversal of the flow of red ink.

Member Firm Profitability

The grim pricture of member firm unprofitability is set forth in stark detail in our full report and there seems little point in reviewing it here. I should point out, however, that the losses cited in the figures published by the Exchange are net losses; that is, they are calculated by subtracting the earnings of profitable firms from the losses of unprofitable firms. Thus, the actual dollar losses of the unprofitable firms are substantially higher than the reported net figures -- and the knowledge that some firms have succeeded in operating in the black has no impact whatever on the financial condition of the majority. It is instructive, therefore, also to look at the monthly gross losses of member organizations. Those figures have been, beginning with October 1973, $7.1 million, $67.5 million, $16.9 million, $11.3 million, $26.2

million, $22.3 million, $54.9 million, $34.4 million, $53.4 million, and, in July 1974, $33.2 million.

More staggering still are the cumulative losses incurred by firms suffering deficits -- an incredible total of more than $170 million since January 1974 alone, and almost half a billion dollars over the 19-month period from January 1973 through July 1974.

These wrenching losses are only partly attributable to inflationary cost increases in the securities industry -- and I should emphasize as strongly as possible that it is only this element of declining financial viability that our rate-increase proposal seeks to redress. I will not review here the calculation of the cost of inflation to the brokerage industry since that is already set forth in full detail in our formal submission. Suffice it to say that postage, stationery and office supplies have climbed 20.2%, advertising and sales literature 12.9%, and most important, clerical and administrative salaries, 10.0%. Overall, the Exchanges' index of member firm unit costs stood 9.2% higher in September 1974 than in June 1973. Rather, I will turn now to the specific calculations by which we determined the amount of revenues needed to offset inflationary cost increases of the past 15 months.

The Dollar Cost of Inflation

While inflation affects most securities industry costs, adjustments must be made for some exceptions. From the basic cost data supplied by member firms, two categories of expense are excluded. First, to the extent that some portion of registered repre-

sentatives' compensation is set as a percentage of gross commission revenues and remains an unchanged percentage throughout the period, its cost to member firms is unaffected by inflation. Second, some expenses involve higher costs which are offset directly on the revenue side; for example increases in interest costs to carry customers' accounts are reflected in higher interest charges to customers carrying margin accounts.

Excluding these specific expense categories, the costs directly affected by price inflation, as reflected in 1973 Income and Expense Report for carrying firms, amounted to $2,247.1 million.

1973 Costs Affected by Inflation
(Millions of Dollars)

Clerical and Administrative Employee Costs	$1,031.4
Communication Costs	401.5
Occupancy and Equipment Costs	372.9
Promotional Costs	150.4
Other Expenses Less Interest Expense	290.9
Total	$2,247.1

The member firm price index shows that the average cost of these goods and services rose 9.24% from the end of June 1973 to September 1974. To obtain the dollar impact of this 9.24% inflation rate on member firms' overall costs of doing business, we deflated actual 1973 costs of $2,247.1 million by 9.24%. The resulting $2,057 million is the total cost which would have been incurred had prices remained unchanged since June 1973. The difference be-

tween the actual and deflated outlays thus comes to $190 million, which is the amount of expenses directly attributable to the impact of inflation since shortly before the last commission rate increase.

Only a portion of that $190 million cost increase, however, is associated with the commission business. In 1973, commission revenues amounted to 61.9% of total revenues less interest receipts from customers' securities accounts. Applying this percentage to the $190 million cost increase resulting from inflation yields $117.7 million in costs attributable to the commission business.

However, it would not be accurate to infer that a rate increase designed to produce an additional $118 million would fully recoup those costs. The reason for this relates directly to methods of compensating registered representatives.

A portion of securities income commission fees is set as a percentage of gross commission revenues. Since a firm's payments of these fees are not affected by inflation, they have been excluded from the cost base. However, in calculating the effect of a rate increase, it is important to recognize that these fees siphon off a significant portion of the additional income generated by any commission rate increase. Therefore, a rate increase designed to yield exactly the calculated dollar amount of cost inflation will not produce enough net revenue to actually offset that amount.

To illustrate, in 1973, the average payout to registered representatives was 19.7% of gross securities commission income generated. If we assume, that about 75% of the average registered representative's

salary is based on commissions generated, then close to $18 million of a rate increase producing $118 million, would go directly to registered representatives, leaving only about $100 million to offset the inflationary cost increases we have calculated.

Clearly, then, somewhat higher revenues are required to offset the actual income drain. To calculate the precise amount needed, however, would require detailed data on the various firms' payment structures for registered representatives. Since such exact data are not readily available, we undertook a survey of member firms to determine an average payout structure for the industry.

The survey indicated that, although there is a perceptible movement toward reducing firms' dependence upon commissions generated, the vast majority of firms still pay their registered representatives on a strict commission basis. Therefore, we believe that our estimate that 75% of registered representatives' commission income relates directly to the generation of commissions may be somewhat conservative. Be that as it may, applying that estimate, we determined that 75% X 19.7%, or 14.8%, must be added to the revenue requirement to fully offset inflationary cost increases. Adding 14.8% to the previously calculated $118 million yields a revenue requirement of $135.5 million.

The Specific Rate Proposal

As I have already noted, our amended rate proposal would eliminate any obligation for firms to increase minimum commission rates on orders up to $5,000.

We have tested revenue effects of this revised proposal and our calculations indicate that an 8% rate increase in the fixed minimum schedule on orders above $5,000 would produce $140 million at an average NYSE daily volume of 15.0 shares. This is slightly more than the $135 million revenue need estimate. However, with prevailing volume levels below the first quarter levels on which our original assumptions were based, revenues would not reach $140 million. Indeed, if volume were to remain at the first half of 1974 average level of 13.6 million shares, the estimated additional revenue from an 8% rate increase would be $126 million.

However, even this figure overstates the probable revenue impact because of the value related structure of the current commission schedule. The estimate is based on the level of stock prices prevailing during the first quarter of 1974, when the Dow Jones Industrials averaged 854. Since then, as you know, prices have slid 23%. Obviously, if we were to further adjust the revenue projection for the price decline, the amount would be considerably below $126 million. In other words, the current rate request, based on early 1974 data, would not fully offset the inflationary price increases, as intended.

AGGREGATE REVENUE IMPACT OF THE PROPOSAL

Two major factors will significantly affect the ultimate revenue impact of the proposed 8% rate increase. The first will be the nature of the commission revenues generated on orders exceeding $300,000. The second, of course, will be share volume levels after the increase goes into effect.

Estimated Effects on Orders Exceeding $300,000

Commissions on orders valued at more than $300,000 are subject to negotiation on the portion of the order exceeding $300,000. Therefore, the revenue effect of a rate increase applicable only to the fixed portion of such an order is difficult to ascertain, since the increase itself becomes a factor in the negotiation process. However, as detailed in our Staff Report, the Exchange believes the effect of a rate increase on negotiated orders will only impact on the fixed commission portion of those orders. Therefore, we estimate that the revenue gain from the 8% increase on trades valued over $300,000 will be $12.3 million.

Revenue Effects with Varying Volume Levels

In forecasting the revenue effects of an 8% commission rate increase, it is necessary to apply an effective level of rate increase to an annualized figure for each of the three categories of order sizes -- i.e., orders valued under $5,000, orders valued between $5,000 and $300,000, and orders valued at more than $300,000. Using preliminary statistics from the NYSE Transaction Revenue Study for the first

quarter of 1974 -- and assuming average daily volume of 15 million shares as in that quarter -- the estimated revenue gain from an 8% rate increase would be $129 million. This is broken down into $117 million from orders between $5,000 and $300,000, and $12 million from orders over $300,000. Also, an estimated additional $10 million would be produced from rate increases already posted by some firms on orders between $2,000 and $5,000. Details on these figures can be found in the Addendum previously submitted.

Commissions of Member Firms
on All Markets, by Value of Order, First Quarter 1974
(Millions)

Value of Order	Amount of Commissions
Under $5,000	$156.3
$5,000 - $300,000	353.8
Over $300,000	60.9
Total	$571.0

Source: TRS, First Quarter 1974 (preliminary)

This "basic revenue yield estimate," assumes that the first quarter 1974 level of average daily volume is the proper one for estimating annual revenue effects. This may or may not be the case. Therefore, we also estimated revenue yields under alternative levels of NYSE average daily volume, as detailed in the additional statistical materials submitted earlier. The volume assumptions range from 13.0 to 17.0 million shares per day and yield revenue estimates ranging from $158 million on the high side to $121 million on the low side.

REVENUE IMPACT BY TYPE OF FIRM

In evaluating the rate proposal, it is also appropriate to examine not only aggregate projected revenues, but also how these additional revenues may be distributed among types of firms.

An 8% increase in the minimum schedule of commissions on orders exceeding $5,000 would produce an effective percentage rate increase for retail firms -- 5.3% -- that is somewhat below the rates for intermediate and institutional firms which are 6.2% and 6.7%, respectively. This is because retail firms, on average, receive a greater proportion of smaller orders than intermediate or institutional firms do. Nevertheless, retail firms would receive only somewhat less than half of all additional projected revenues. Retail and intermediate firms combined would receive almost 81% of all revenues generated by the rate increase.

The additional dollars would, of course, affect profitability for each group of firms. Operating margins and rates of return are two indicators commonly used for measuring such profitability.

To calculate the effect of the NYSE rate proposal on operating margins, it is necessary to make alternative assumptions on the additional revenues flowing through to pre-tax profits. The actual percentage depends on industry practices relating to registered representatives' compensation and the increase in other variable costs resulting from the higher rate schedule. If, for example, a 75% flow-through is assumed, the aggregate pre-tax operating margin of retail

firms would rise from -1.4% to 0.5%; from -5.1% to -2.3% for intermediate firms; and from 0.2% to 2.6% for institutional firms. All firms combined would show a rise from the -2.2% experienced in the first half of 1974 to 0.0%.

As the figures indicate, the additional revenues would not have raised operating margins of any group to a level which could possibly be deemed excessive. Indeed, the added revenues would barely have brought the industry back to a break-even operation during this period.

Similarly, pre-tax return on invested capital for member firms would still be disconcertingly low -- between -1.0% and +1.1%, depending upon the flow-through assumption. Institutional firms, assuming a full 100% pass-through, would have the highest return on capital -- 3.7%.

* * *

In conclusion, I should stress again that the rate adjustment we are requesting is designed to do no more than offset the drastic impact of inflationary cost increases on the securities industry. An 8% increase will not restore profitability. That will depend on the effectiveness of other nation-wide efforts to de-escalate costs and restore a measure of public confidence in the prospects for stable national economic growth. Only then may we confidently expect a reversal of the long-continuing decline of stock prices and volume.

In the absence of effective national anti-inflationary policies, almost any inflation-related rate increase faces the prospect of

inadequacy soon after its effective date. Treasury Secretary Simon has predicted -- and I quote -- "At the end of this year, after the food and fuel and other special factors have receded, our price levels will probably still be rising by something in the neighborhood of 9% per year, perhaps more." End of quote.

I hope Secretary Simon is wrong. But if he is right, then we can expect even the current rate-increase proposal to fall short of its goal of offsetting inflation -- by about 3% -- as soon as next January.

In approving the Exchange's last rate increase request, the Commission noted that the Exchange's submission of information "clearly showed that its member firm community had been experiencing severe financial losses for a substantial period preceding the rate request."

It gives us no pleasure to suggest that our present submission of information is equally persuasive. The securities industry's need for rate relief is painfully apparent. And while affirmative action by the Commission will still leave the industry a long distance from the goal of a measure of profitability sufficient to retain and attract essential investment capital, we earnestly urge you to take at least this minimal step that will allow the industry some relief from the inflationary treadmill that has been steadily sapping its vigor.

ADDENDUM TO "THE CRISIS OF MEMBER FIRM PROFITABILITY AND THE NEED FOR A SECURITIES COMMISSION RATE INCREASE": REVISION OF SPECIFIC RATE PROPOSAL

On page 42 of the New York Stock Exchange staff report, entitled "The Crisis of Member Firm Profitability and the Need for a Securities Commission Rate Increase", a specific rate increase was proposed. This increase, 7% in the fixed minimum schedule on orders above $2,000 (commissions on portions of orders in excess of $300,000 are negotiated), was designed to produce about $141 million at an average NYSE daily volume of 15.0 million shares.

The Board of Directors of the Exchange, recognizing the importance of current rate experiments on smaller orders, has concluded that a mandatory increase in the minimum rate schedule should not begin with orders as low as $2,000. Rather, the Board believes that the public interest would be better served by a rate increase beginning at the $5,000 level. Consequently, the Exchange has amended its specific rate proposal to one of 8% in the fixed minimum schedule on orders above $5,000.

This revision was made primarily for the purpose of allowing the small investor to retain the ability to choose a broker on the basis of commission rate differences. According to an Exchange analysis of recent commission rate patterns of member firms, more than half of all retail brokerage firms have raised commission rates on small orders above the current NYSE minimum level. Most of these increases have

approximated 5%. Had the original rate proposal been enacted, many of these differentials would have been eliminated by the raising of the minimum rate. By starting at a higher cutoff level, i.e., $5,000 rather than $2,000, the revised rate proposal preserves the competitive experiment on these smaller orders.

The Specific Rate Proposal. In determining the specific rate to apply on orders exceeding $5,000, the revised proposal was designed to yield a total revenue as similar as possible to the original proposal, i.e., approximately $141 million at a volume level of 15 million shares per day on the NYSE. Using the methodology described in the staff report on pages 43-47, it can be shown that a rate increase of 8.7% would yield the specified $141 million. The relevant calculations are shown in Table 1.

Table 1

Estimated Annual Revenue Yields
From An 8.7% Increase On Orders Above $5,000
(millions of dollars)

	Commissions During 1st Q. 1974	Annualized Commissions	Effective Increase	Yield From Proposed Rate Increase
Orders Under $5,000	$ 156.3	$ 646.2	0.00%	$ 0.0
Orders from $5,000-$300,000	353.8	1464.7	8.70%	127.4
Orders Over $300,000	60.9	252.9	5.31%	13.4
Total	$ 571.0	$ 2363.8	5.95%	$ 140.8

While a rate increase of 8.7% would produce the desired $141 million on orders exceeding $5,000, consideration must be given to the fact that additional revenues would also continue to be generated on orders

between $2,000 and $5,000 as a result of the individual firm rate increases, which would still be in effect. On the basis of an Exchange analysis of these rate increases, it is estimated that a <u>maximum</u> of $12.7 million would be generated annually on orders between $2,000 and $5,000 from these increases, once again assuming 15 million shares per day on the NYSE.

The above figure is labelled as a "maximum" because it implicitly assumes that all potential orders are affected. However, it is known that some portion of these orders emanate from institutions, and virtually all member firms specifically exclude institutional orders from these increases. Therefore, to the extent that some portion of these orders are institutional in origin, the $12.7 million revenue estimate is an overstatement. Unfortunately, it is not possible to make a precise estimate of the proportion of orders affected, but if the institutional portion is roughly estimated at 20%, then it can be assumed that the additional revenue generated by these increases is in the neighborhood of $10 million annually.

Since it is desired that the total annual revenue effect on orders above $2,000 be approximately $141 million, consideration of the above factor reduces the revenue requirement from the rate increase on orders above $5,000 to about $131 million. Once again, using the methodology described earlier, the specific level of increase on orders above $5,000 necessary to produce this $131 million can be calculated. The actual percent increase calculated, 8.09%, can be reduced to the less cumbersome figure of 8% at the sacrifice of about $1.5

million annually, producing a total revenue estimate of $129.5 million + $10 million, or $139.5 million. The calculations relevant to the 8% increase are shown in Table 2.

Table 2

Estimated Annual Revenue Yields
From the Amended Rate Increase
(8% on Orders Exceeding $5,000)
(millions of dollars)

	Commissions During 1st Q. 1974	Annualized Commissions	Effective Increase	Yield From Proposed Rate Increase
Orders Under $5,000	$ 156.3	$ 646.2	0.00%	$ 0.0
Orders from $5,000-$300,000	353.8	1464.7	8.00%	117.2
Orders Over $300,000	60.9	252.9	4.88%	12.3
Total from Increase	$ 571.0	$ 2363.8	5.48%	$ 129.5
Plus: Estimated Increases on Individual Orders between $2,000 and $5,000				10.0
Grand Total				139.5

Table 2 provides a "basic revenue yield estimate", assuming that the first quarter 1974 level of average daily NYSE volume (15.0 million shares) is the proper one for estimating annual revenue effects. Since this may or may not be the case, a table showing revenue yields at alternative levels of NYSE average daily volume is also provided. Table 3, on the next page, shows these alternative revenue yields, using the same methodology employed in producing Table 6 in the staff report (see pp. 47-50).

Table 3

Impact of Revised NYSE Proposal on Commission Revenues Under Alternative Volume Assumptions

Average Daily Volume on the NYSE (Millions of Shares)	Adjustment Factor	Revenue Yield (Millions)
13.0	0.866	$120.8
13.5	0.900	125.6
14.0	0.933	130.2
14.5	0.966	134.8
15.0	1.000	139.5
15.5	1,033	144.1
16.0	1.066	148.7
16.5	1.100	153.5
17.0	1.133	158.1

Revenue Impact by Type of Firm. Since the revised rate proposal is designed to produce an aggregate revenue effect similar to that of the original proposal, the major differences between the two proposals is the effect on the various types of firms within the industry. Using the methodology developed on pp. 51-55 of the staff report, various effects on the retail, intermediate, and institutional segments of the industry are estimated.

Table 4 shows the estimated revenue effect of the 8% rate proposal on the three categories of member firms, as well as an estimated distribution of the $10 million generated by unilateral increases on orders between $2,000 and $5,000. As the table shows, retail firms would receive a smaller relative proportion of the projected revenues from the revised proposal, compared with the earlier one. However, the addition of the increased revenues from individual firm rate increases

on orders between $2,000 and $5,000 produces a net effect in which the projected revenue distribution does not differ significantly from that of the earlier proposal.

Table 4

Impact of Revised NYSE Proposal on Commission Revenues of Member Firms Based on First Quarter 1974 TRS Data (millions of dollars)

Type of Firm	Estimated Annual Commissions	Increase in Commissions from Revised Proposal	Increase from Individual Increases on Orders Between $2,000-$5,000	Total Increase Generated	Effective Rate Increase
Retail	$ 1,221.0	$ 58.5	$ 8.2	$ 64.7	5.30%
Intermediate	774.4	46.2	1.7	47.9	6.19%
Institutional	368.5	24.7	0.1	24.8	6.73%
All Firms	$ 2,363.8	$ 129.4	$ 10.0	$ 139.4	5.90%

Effects on Operating Margins and Rates of Return. Since the actual dollar revenue effects on each type of firm do not differ materially between the two proposals, the effect of the revised proposal on operating margins and rates of return will likewise not differ materially from that of the earlier proposal. Therefore, the relevant tables concerned with these items in the staff report (pp. 53-55) are revised on the following page without detailed analysis.

Table 5

Impact of Revised NYSE Proposal on Pre-Tax
Operating Margins of Member Firms, First Half, 1974
(millions of dollars)

	Retail	Inter-mediate	Insti-tutional	All Firms
Pre-Tax Profits	$ (16.1)	$ (31.1)	$ 0.6	$ (46.6)
Gross Revenues	1127.9	607.7	335.7	2071.3
Operating Margin	-1.4%	-5.1%	0.2%	-2.2%
Additional Revenue	29.1	21.6	11.1	62.8
Assumptions of Flow-Through to Net Profits				
	Pre-Tax Operating Margin			
100% to Net Profits	1.1%	-1.5%	3.4%	0.8%
75% to Net Profits	0.5%	-2.3%	2.6%	0.0%
67% to Net Profits	0.3%	-2.6%	2.3%	-0.2%
50% to Net Profits	-0.1%	-3.2%	1.8%	-0.7%

Table 6

Impact of Revised NYSE Proposal on Returns on
Capital of Member Firms, First Half, 1974
(millions of dollars)

	Retail	Inter-mediate	Insti-tutional	All Firms
Pre-Tax Profits (unadjusted)	$ (16.1)	$ (31.1)	$ 0.6	$ (46.6)
Average Capital*	1537.5	885.1	628.7	3051.3
Annualized Rate of Return	-2.1%	-7.0%	0.2%	-3.1%
Additional Revenue	29.1	21.6	11.1	62.8
Assumptions of Flow-Through to Net Profits				
	Return on Capital			
100% to Net Profits	1.7%	-2.1%	3.7%	1.1%
75% to Net Profits	0.7%	-3.3%	2.8%	0.1%
67% to Net Profits	0.4%	-3.7%	2.5%	-0.3%
50% to Net Profits	-0.2%	-4.5%	2.0%	-1.0%

* Based on the average capital figure for each firm in January 1974 and June 1974.