TESTIMONY OF THE HONORABLE RAY GARRETT, JR., CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, ON S. 249, 94th CONG., 1st SESS.

(February 19, 1975)

Mr. Chairman, members of the Subcommittee:

I am here, together with my fellow Commissioners, for the purpose of presenting the Commission's views on S. 249, which is, by-and- large, although not precisely, an amalgam of five bills either passed by the Senate or extensively considered by this Subcommittee during the last session of Congress.

There is much too much in this legislation for me to cover all of our comments in my oral presentation. We are putting them all in a written statement, and we have advised your staff that they will be available next week. I will. limit myself this morning to a few points that seem, to us of the most importance. Needless to say, we will be happy to expand our remarks on any matters at your request, either this morning or at a later time.

To state our position clearly at the outset, we strongly support S. 249 subject, only, to a few changes.

A major underlying premise of S. 249 is to provide an explicit legislative basis for many of our efforts to facilitate the development of a national market system. We have, of course, proceeded with our efforts to assist the securities industry in developing a national market system while this legislation has been pending in Congress, and we shall continue to do so; but, we welcome the clear legislative expression of support, confirmation and grant of ' authority for these efforts that S. 249 would provide.

Since I last testified before this Subcommittee, a number of important developments have occurred.

As you are no doubt aware, on January 23rd of this year, the Commission adopted Securities Exchange Act Rule 19b-3, requiring the elimination of fixed commission rates on exchange transactions. Our adoption of Rule 19b-3 marked the culmination of many years of hearings and studies, not only by the Commission, but by the Congress, including this Subcommittee, and others as well. We are grateful for the support and encouragement we have received from this Subcommittee, and particularly its Chairman, in regard to this whole difficult matter.

Similarly, the pilot phase of the consolidated tape has, since we last testified, become a reality. Although full implementation of the consolidated tape for all New York Stock Exchange-listed securities may be deferred until early this summer, we are encouraged by the results of the pilot phase, which

could not have been achieved without the cooperation of the securities industry generally, and the Consolidated Tape Association in particular.

During this time, further advances have also been made toward a uniform net capital rule, a national clearing system and the development of a set of governing principles for the national market system. On this last matter, our Advisory Committee on the Implementation of the Central Market System, chaired by Alexander ("Sandy") Yearley, IV, of Atlanta, Georgia, is making meaningful progress .

Despite these efforts, and the commendable attitude of the industry we regulate to cooperate to the fullest extent practicable, there are still important reasons why S. 249 should be adopted promptly.

For one thing, the outmoded legislative formulations in our present statutory charter have forced us to rely on implicit and indirect legislative sanction for some of our efforts and progress. S. 249 would make our acknowledged authority explicit, and the Congress's intentions unambiguous.

The legislation also would extend, or specify, for the first time, our direct authority over such important subjects as the disclosure of institutional transactions and portfolio holdings, municipal bond dealers, and transfer agents, depositories and clearing agencies. These are important, emerging areas, where our present authority is unduly limited or nonexistent, and the protection public investors receive is in need of improvement.

Of equal, and perhaps even of more, importance, however, this legislation also should prove extremely useful and reassuring to the members of the securities industry and those who rely on the services they perform.

Preservation of Exchange or Auction Markets

For example, in connection with our proposal, and now our rule, requiring the elimination of fixed commission rates, members of the securities industry have argued that the markets that exist on national securities exchanges could be impaired by what they see as the removal of a principal incentive to broker-dealers to retain stock exchange membership and to take orders to the floor. We have expressed our doubts about the likelihood of such an occurrence, but we have supported legislation which would permit us to prevent any severe market disruptions that might be caused by the transition to a system of unfixed rates. S. 249, as is true of its predecessor, S. 2519, contains ample provision to permit us to act decisively and effectively, if developments require.

While enabling us to act quickly and appropriately, S. 249 takes a broad view of what it is that we are meant to protect. Some spokesmen for exchange member firms have sought to persuade the Congress to adopt or at least to direct us to take all measures necessary to protect the auction market, however defined, as presently conducted on the floor of the New York Stock Exchange from any erosion or even alteration, and to take these measures, in an anticipatory way in advance of the day when public rates actually become

free of compulsory minimums. In Section 6, on page 41, of S. 249, proposing a new Section 11A(c)(4) of the Act, the Congress would, wisely, we think, have us consider such protective measures only after public rates have become unfixed. At the same time, the bill describes the thing to be protected as not necessarily the present exchange markets in every detail, but rather the "fairness or orderliness of the markets r for [listed] securities" as they relate to "the public interest or the protection of investors ." In so acting, we must also avoid any unreasonable restriction on competition.

Because of its importance to so many in the industry, I would like to restate our understanding of the intent of new Section 11A(c)(4). We may adopt a rule prohibiting broker-dealers from effecting transactions in listed securities otherwise than on a national securities exchange, but only if we find, first, that such a rule is "necessary or appropriate in the public interest or for the protection of investors to restore or maintain the fairness and orderliness of the markets for such" securities," and, second, that no exchange rule would "unreasonably impair the ability of any dealer to solicit or effect transactions in such securities for his own account or unreasonably restrict competition among dealers" or between specialists and other market makers. And these findings can only be made after notice and opportunity for hearing and after public commission rates have become unfixed, that is to say, after May 1, 1975.

Our reading of 11A(c)(4) presumes that the limitations on Commission action prior to the elimination of "fixed commission rates" refers to fixed

public commission rates, and not so-called intramember rates. This was the view expressed in the report accompanying S. 2519. In order to clarify any uncertainty, the Subcommittee may wish to amend proposed Section HA(c)(4) and other places where this phrase occurs to make this interpretation explicit.

This is the provision that was settled upon in S. 2519, and we think it is a good one, having in mind all of the sharply conflicting considerations involved. We understand that it does not prevent our considering and-adopting, if we see fit, other less drastic measures, either before or after May 1, 1975, which may have a tendency to discourage present members of exchanges from leaving them in favor of handling their customer business "upstairs," so to speak, as dealers and third market makers. In our release announcing the adoption of Rule 19b-3, we stated our intention of-exploring the possibilities in that direction and solicited comments. No decisions have yet been made in this regard.

Fixed Commission Rates

As I have already indicated, the Commission's adoption of Rule 19b-3, eliminating fixed commission rates on exchange transactions, concludes a major chapter in the evolution of the nation's securities markets. Although we have long been embarked upon a process of phasing in a system of unfixed rates, we have urged both this Subcommittee, and its counterpart in the House of Representatives, to vest in the Commission continuing flexibility and

discretion to deal with the problems of commission rate charges and any untoward effects that might result from the unfixing of rates. We believe the bill currently before you will accomplish these important functions.

Thus, although we do not now foresee the likelihood that we will someday believe it appropriate to reimpose fixed rates for exchange transactions, there is no question that, should such an act be necessary or appropriate, we would have the power to do so under our existing authority. Proposed new Section 19(b)(2), as set forth at page 121 of S. 249, would also grant us sufficient flexibility, pursuant to a reasonable statutory standard, to approve any proposals to reinstitute fixed rates at some future time. This is commendable and a desirable improvement over the prior drafts of this legislation.

Specifically we note the change in legislative approach from last year's Senate bills and the proposed legislation in the House. S. 470, in the 93rd Congress, would have addressed the question of fixed commission rates only to say that an exchange could not impose any limitation on so-called institutional membership so long as rates remained fixed. H.R. 5050, in the 93rd Congress, and the present H.R. 10, would prohibit fixed rates after May 1, 1975, with authority in the Commission to permit their continuance or reinstatement until October 1, 1976, upon making certain findings, and beyond the latter date only after making some much more difficult, if not improbable, findings.

The approach of S. 249 is to say that we may permit an exchange to fix rates of commission, etc., but only if we find that they are “reasonable in relation to the costs of providing the service for which such charge sis made” as well as “necessary to accomplish the purposes of this title” and we must publish the standards employed in adjudging reasonableness.

This seems to us to get more to the heart of the matter, as a viable, long-term proposal. I don't want to encourage widespread false hopes. The New York Stock Exchange went to considerable effort and expense not long ago to develop a cost-related basis for a fee schedule and failed to devise one that was generally acceptable to its members. None was ever presented to us for formal consideration. And we might have much trouble concluding that, even on such a cost basis, fixed rates would be necessary to accomplish the purposes of the act. But if a long-range resolution is ever going to come about, this is the way. Accordingly, we favor the provisions of S. 249 on. this subject over the longer term.

Nevertheless, there remains the possibility that, over a much shorter period of time — say a year or eighteen months the immediate consequences of unfixed commission rates might require rapid administrative responses. While the current provisions of S. 249 conditioning the re-imposition of fixed rates make sense for the long term, we believe that S. 249 should not, in the short run, make it unduly difficult for us to reimpose fixed rates in a hurry, if necessary. The cost analysis called for by S. 249 might preclude any reasonably prompt action. In this context, the Commission believes the

Subcommittee should consider amending S. 249's proposed new Sections 6(e) and 19(b)(2) of the Act to make clear that the new standards for fixing commission rates are applicable only after October, 1976, and that, prior to that time, the Commission can reinstitute fixed rates on exchanges more promptly, upon a finding that the fairness or orderliness of the markets may otherwise be impaired.

Research and Other Brokerage Services

The transition from a system of fixed to unfixed commission rates is expected by some to cause confusion and disruption. A significant issue, which can affect many investors, is the future availability and quality of research and other services in an environment of unfixed rates, from the point of view both of the purveyor and the issuer.

Under the present system of fixed rates, for example, most money managers, and especially the smaller ones, obtain supplementary research support and services, or, perhaps, all of their needed research services, from brokerage firms which execute their transactions on a national exchange for a fixed commission. The fixed commissions have supported the cost of generating research upon which so many money managers have relied, to the benefit of the accounts under their management. This is a complex problem, and I would like to take a little time to make our thinking clear.

One of the economic anomalies of fixed commission rates is that they have covered a multitude of services 'and presented a multitude of opportunities, indeed, temptations. When broker-dealers cannot compete on the price of their basic services, they compete on services they can render for the price. When money managers cannot vary the price they pay for basic services, they use the-payments-to obtain other services.

Many broker-dealers have, therefore, developed a research capability as a means of attracting brokerage business, especially institutional brokerage business, and, if they obtain enough brokerage business, the fixed rates have evidently produced revenues adequate to make the providing of research quite profitable. Firms that have relied heavily on research (rather than superior execution, ability to position, access to attractive block's and purchasers, for example) fear that they will suffer severely if commission rates are forced down by competition from non-research houses to the point where they will not provide adequate compensation for research.

Money managers are faced with the other side of the problem, so to speak. In establishing their money-management arrangements, whether as trustee, pension fund manager, mutual fund manager, or what not, they have known and presumably relied on the fact that portfolio activity at fixed rates was going to result in broker-dealers tendering them “free” research. What the broker-dealer typically expects for his research is commission business. The compensating commission business need have no relation to the subject matter of the research. Indeed, the schedule for allocating brokerage has often

been on an annual basis, after the manager has reviewed the research and other services rendered during the past year by all of the dozens or even hundreds of firms with which he has done business.

Money managers come in all shapes and sizes and with many different philosophies. Some very large bank trust departments have large and growing research departments and profess to rely very little on so-called street research. Some smaller bank trust departments have no research staff and rely quite heavily on street research. Other types of money managers also vary widely in these respects. But competition and custom have caused investment management fees to be pretty standard. Certainly the small trust department has not been able to charge higher fees than the large one, even though the large one has enough volume to sustain an in-house research capability and the small one does not. The immediately important consideration is that, consciously or otherwise, investment management arrangements, including “the management fee, have been entered into in contemplation of securities market practices that would enable the manager to obtain broker-dealers research and other services out of commission expense, which is customarily chargeable to the portfolio, not to the manager. Certain state laws, regulations and customs governing the maximum administrative expenses chargeable to a trust estate, mutual fund or other managed portfolio have contemplated the same circumstance.

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We are now faced with the effect on these arrangements of competitive commission rates. If governing law applicable to fiduciaries — and all money managers are fiduciaries even though all are not properly to be regarded as trustees, and there are differences — dictates that the money manager must always seek the lowest cost of execution of portfolio transactions and that he cannot charge the estate or managed fund with an execution-plus-research rate that is higher than an execution-only rate, he is faced with a problem. If he can obtain research and other services formerly covered by fixed commissions only by charging himself with the higher portion of the commission or by paying with his own hard dollars with non-reimbursement from the estate or fund, an arrangement which has been satisfactory to all parties may suddenly become an unfair loss operation for the investment manager.

Because of this clear possibility, we believe that some relief is called for at the Federal level. The Federal government has precipitated this crisis, if it is a crisis, and the Federal government ought to help solve it. Of the various efforts at legislative solutions that we have learned of and considered, we think the draft proposal that has been circulate by the Subcommittee's staff is the best. It covers bank trust departments as well as other investment managers, it avoid the necessity of tracing the imputed value of any specific research to a specific account, it avoids any temptation to abuse, and it permits a State through subsequent legislation to govern the matter differently if it so desires. These are necessary attributes to any Act of Congress that hopes really to be helpful.

The whole matter is quite complicated and full of uncertainties. We don't know, and at this stage can't know for certain, how competitive rates will develop. We don't know exactly how legal counsel for money managers will react, and their reactions may well vary. We hope, however, that this provision will encourage money managers to exercise their reasonable judgment. We assume that those money management contracts that can be renegotiated as a practical matter will be in the course of time as new patterns develop, even though some, like many testamentary trusts with unborn remaindermen, may, as a practical matter, be beyond renegotiation. Finally, we will be quick to request repeal or modification of the provision if unanticipated abuses develop.

On the whole we strongly favor relief in this area, and we commend fJie Subcommittee and its staff for proposing, in its draft amendment, the best solution we have seen.

Trading by Exchange Members

As was in part true of S. 470 last session, Section 5 of S. 249, on page 26, proposes to amend Section 11(a) of the Act to restrict the ability of member firms to trade for accounts in which they have a significant financial interest or for accounts which they manage. The Commission, as this Subcommittee is aware, previously adopted a rule — Securities Exchange Act

Rule 19b-2 — to regulate the extent to which exchange members can trade for their own or managed accounts.

In our view, developments not present when we first adopted Rule 19b-2, and when S. 470 was passed — such as the elimination of fixed exchange commission rates, and creditable progress toward the development of a national market system — call into serious question the need for a legislative formulation to deal with this issue, and particularly a legislative formulation too rigid to permit the Commission to adjust its rules to changing conditions and circumstances.

We urge the Subcommittee to leave this issue to flexible Commission rulemaking.

Procedural Provisions

Much of last year's discussions between the respective staffs of this Subcommittee and the Commission focused upon the procedural and judicial review provisions of S. 2519. Although we had urged less cumbersome procedural and review provisions, S. 2519, as finally passed, reflected sound legislation. These provisions have, in a number of instances, been materially changed.

Thus, proposed new Section 25(b), which provides for direct appellate review of certain Commission rules, contains no standards for review of our

rules and, the first time, permits the appellate courts to restructure as well as prolong a Commission rulemaking proceeding. Both changes would impede the effectiveness of rules concerning the national market system, and represent to us an unwarranted departure from the legislation passed just last year.

This is rather technical but of grave concern to us. Since we understand from the Subcommittee's staff that these provisions will be changed to conform to S. 2519, I do not intend to spend any more time on this issue.

Confidential Treatment

Notwithstanding the recent strengthening of the Freedom of Information Act, Section 18 of S. 249, on page 145, proposes to amend Section 24 of the Act to impose even heavier burdens on the Commission, apparently making it difficult in certain circumstances, for us to rely on even those exemptions from disclosure contained in the Freedom of Information Act available to all other federal agencies.

We fail to understand why the Commission should be required to meet a more rigorous test for sensitive information than any other agency, and urge this Subcommittee to withdraw its proposed revision of Section 24.

Commodity Futures Trading Commission Act

I also should like to suggest that the Committee consider amending Section 28 of the Securities Exchange Act of 1934 to resolve certain questions concerning the jurisdiction of the Securities and Exchange Commission, and the applicability of the federal securities laws to transactions in certain types of securities, which may arise when the provisions of the Commodity Future's Trading Commission Act of 1974 ("CFTCA") . become effective on April 21, 1975.

As you may know, the broad definition of the term "commodity" set forth in the CFTCA, as well as the provisions of that Act granting exclusive jurisdiction to the new Commodity Futures Trading Commission, read together, arguably could be construed to preempt the jurisdiction of this Commission., and to vitiate the applicability of the federal securities laws, with respect to transactions in such "traditional" securities as convertible bonds, debentures, warrants and securities options, as well as the markets for such securities. If so interpreted, the CFTCA could cause the present structure for the regulation of securities to be replaced by a statutory scheme designed to regulate commodity futures trading, and might result in inconsistent regulation of substantially similar transactions. In addition, to the extent that the jurisdiction and authority conferred on the new Commodity Futures Trading Commission is not comparable to the jurisdiction and authority of the SEC which may be preempted by the CFTCA, certain aspects of the securities markets may tie inadequately regulated, or not regulated at all.

The Commission does not agree, of course, that the CFTCA could or should be interpreted to have these undesirable, and wholly unintended, effects. Indeed, statements presented by Senator Talmadge and Congressman Poage on the floor of the Senate and the House, respectively, at the time the Conference Report on the CFTCA was considered by the Congress, make clear that that Act was not intended to deprive this Commission of jurisdiction in these areas. But, we believe it essential that these ambiguities be resolved in order to preserve the existing comprehensive regulatory pattern specifically designed by the Congress to regulate transactions in securities, and to ensure that investors in securities continue to receive the important protections provided by the federal securities laws.

A detailed discussion of the bases for the Commission's concerns in this regard, and proposed corrective legislation, amending Section 28 of the Exchange Act, are set forth in a letter by the Commission, dated February 14, 1975, in response to an earlier inquiry concerning the CFTCA from Chairman Staggers of the House Committee on Interstate and Foreign Commerce. With your permission, I should like to submit copies of this correspondence for the record of this hearing.

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It is our hope that securities legislation can pass the Congress quickly, so that the Commission and the securities industry can concentrate their

efforts on meaningful restructuring of our securities markets. With appropriate modifications, we whole-heartedly endorse the passage of S. 249.