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ZERO MINUS SIXTEEN AND COUNTING

Address by

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Securities and Exchange Commission
Washington, D.C.

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Hartford, Connecticut
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In just sixteen days, the countdown to competitive commission rates will be completed and the fixed rate barrier removed so that market forces will begin to influence public commission rates charged for securities transactions on exchanges. This step represents a fundamental change in the traditional exchange rate mechanism, and it can be expected to have significant effects on competition for business among participants in the securities industry.

As is true with any major change regarding an established pattern of business operation, there has been and continues to be substantial opposition to the Commission's decision requiring competitive rates, and some honorable and well-meaning people have made dire predictions as to the eventual results of the change. It has been predicted that competitive rates will destroy the New York Stock Exchange as well as the other exchanges in the country, create confusion and chaos in the markets for securities, destroy the greatest financial communications system the world has ever known, reduce the participation of small investors in our securities markets, bring about destructive competition and thus cause a high rate of failure among broker-dealers and concentrate the securities business in a handful of firms, lower the standards

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in the industry, weaken desirable surveillance mechanisms that protect public investors, reduce the depth and liquidity of our markets, eliminate public markets for many securities, destroy our capital raising mechanism and bring about the downfall of our free enterprise system.

May 1, the day by which barriers to competitive rates must be removed, is sometimes referred to as "Mayday," a term used as an international distress signal. One witness at our recent 19b-3 hearings concerning whether to adopt a rule prohibiting exchanges from fixing minimum public commission rates repeated the Mayday reference and added, "I would like to carry this one step further. Mayday is a great holiday in Russia. And Russia has said there is no need to fight democracy. It will burn itself out. Well, Commissioners, you have the candle and the matches, and it will be a short fuse."

These statements covering practically all imaginable adverse possibilities indicate strongly-held beliefs which are not to be brushed aside lightly. We who bear the burden of this decision feel very keenly the responsibility that is ours. Nevertheless, the dire predictions and the not so subtle suggestions that we are "socialist-guided" or are lighting a short fuse to burn out our democratic form of government have not deterred us from requiring the removal of barriers to competitive rates, because, after careful consideration, we have concluded that "the free play of competition can provide

a level and structure of commission rates which will better serve the interests of the investing public, the securities markets, the securities industry, the national economy and the public interest than any system of price fixing which can be reasonably devised."[1]

This does not mean that on May 1 Adam Smith's invisible hand of competition will wave a magic wand and everyone will live happily ever after. In fact, the winds of competitive change will be very harsh on some present participants in our securities markets and require the Commission to be especially alert during the transition. Broker-dealers who have been successful only because their customers were unable to compare readily an inferior package of services included within a fixed commission charge with the services offered by competitors and thus detect that they were not receiving full value for their money, will find it difficult to retain customers when others offer the same services for a commission which is obviously lower. Research services which cannot be absorbed by broker-dealers as an advertising expense or as a sales tool and which have existed, not because customers were willing to pay for them, but only because they were provided at no extra cost within a fixed commission rate, may find it difficult to survive under a competitive rate structure in which customers will be able to choose to forego

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1/Securities Exchange Act Release No. 11203, p. 23 (Jan. 23, 1975).

services which they either do not want or which they believe do not justify higher prices.

To the extent a marketplace has built its operations solely on its ability to provide a mechanism to escape or circumvent the fixed commission rate charges on the New York Stock Exchange, it may find that the waves of competition will wash away the sand on which it is founded. At the same time, a marketplace which has maintained its position through rules and practices restricting access to its facilities and restricting the ability of its members to trade other than in that marketplace, even though a better execution could be obtained elsewhere, will find that competitive forces will erode the effect of such restrictive rules and practices and that for competitive reasons its own members may bring pressure to remove such restrictions.

There is no doubt in my mind that every segment of the securities industry will feel the effects of competitive rates, and I fully expect a whole new set of relationships to evolve, both within the industry and between industry participants and their customers. As these relationships develop, I believe we will find that some present restrictions and requirements will not be needed to protect investors and the public interest, and that adjustments in our present regulatory structure will be appropriate. However, we cannot make all of these changes in advance as some have requested, because we cannot foresee exactly how the new relationships will

develop as market participants interact with each other in response to the new competitive environment, and premature regulatory changes might result in thwarting some benefits that could accrue if relationships are allowed to develop without new restrictions. The Commission, however, must be aware of developments resulting from competitive rates and be prepared to respond quickly to changes that might have an adverse effect on our securities markets, endanger the public interest or reduce the protection of investors.

Accordingly, the Commission is taking steps to increase the scope of our market monitoring activities after May 1. We have proposed and published for comment a fairly comprehensive program, including proposed Rule 17a-20,[2] designed to provide the Commission with information which would indicate changes in services being offered, commission rates being charged individual and institutional customers, changes in the distribution of trading among competing marketplaces, and changes in expenses and revenues of broker-dealers and self-regulatory bodies. This information would be gathered primarily through broker-dealer financial reports and interviews with market participants, and the reporting would be coordinated with present filing requirements so as to balance the need for additional information with our desire to minimize reporting burdens.

2/Securities Exchange Act Release No. 11293 (Mar. 13, 1975).

Proposed Rule 17a-20, among other things, would require exchange members to file a report of their intent to resign from exchange membership, a statement of their plans for effecting and reporting securities transactions as non-members and a copy of their notice to customers as to the effect such resignation would have on their future ability to service customers. This proposal should not be interpreted to mean that the Commission will take action to require exchange members to retain their exchange membership. The Commission has not made such a decision nor is it likely that we will, unless, through experience, we find that such a requirement is necessary to maintain fair and orderly securities markets and to protect investors.

Despite the Commission's determination to utilize "prudent gradualism" in implementing competitive rates in order to soften the impact of this change on the securities industry, the final transition will not occur without problems. The Commission has already begun to take action in areas where we believe adapting to competitive rates could result in undesirable disruption of normal business relationships.

Under fixed commission rates, broker-dealers who are also registered as investment advisers provide customers certain impersonal investment advice, such as publicly distributed written materials or statistical information, as a service incidental to their business as a broker or dealer and do not charge separately or otherwise receive special compensation for such services. So long as those services are

provided on this basis, the conduct does not come within the definition of an investment adviser under the Investment Advisers Act of 1940. However, if a firm registered both as a broker-dealer and an investment adviser were to decide to charge separately for this service in a competitive rate environment, the separate charge would be deemed special compensation, and various Advisers Act provisions would apply, including Section 206(3) which requires that an investment adviser, prior to the completion of a transaction, disclose to the client whether he is acting as a principal for his own account or as a broker for another person and obtain the consent of the client to the transaction.

A brokerage firm that regularly distributes large quantities of market letters and related pricing or valuation services may find it difficult or impractical to determine whether it has acted as an investment adviser in connection with trades where it acts as a broker or dealer. Furthermore, the notification requirement of Section 206(3) would impose heavy administrative burdens on the firm, and, because the timing of executions is important, certain price benefits might be lost if the firm were required to comply with the provisions of the Section. Thus, the Commission has proposed Rule 206(3)-1[3/] to afford investment advisers who are registered as broker-dealers an exemption from Section 206(3) with respect to their activities in providing certain impersonal investment advisory services.

3/Securities Exchange Act Release No. 11324 (Mar. 31, 1975).

Moreover, the receipt of separate payments by broker-dealers not registered under the Advisers Act for incidental and impersonal investment information also would be deemed as receiving special compensation by a person acting as an investment adviser, and, if an exemption were not available, such broker-dealers would be subject to the registration provisions of the Advisers Act. The Commission is now considering a temporary rule which would be effective May 1, 1975, that would exempt such broker-dealers from the Advisers Act for a short period of time. One of the areas of concern in this regard is whether it is necessary for broker-dealers not registered as investment advisers to be required to register under the Advisers Act in instances where only impersonal advisory services are provided, which, in the past, have been considered incidental to a broker-dealer's business. I favor a temporary rule providing relief in this area which would allow the Commission time to gain experience in order to make a determination whether applying the Advisers Act is necessary for investor protection under the circumstances.

Without proposed Rule 206(3)-1 and the proposed temporary rule, provisions of the Advisers Act would operate as regulatory impediments to unbundling of services, and it seems desirable to allow market forces to determine whether services are offered separately or in a bundle after May 1, 1975. It can be expected that, as other similar impediments to the

operation of desirable market forces are perceived, the Commission will be prepared to undertake whatever action is necessary to remove such impediments.

Another problem which has generated a great deal of concern and for which a solution has been sought by broker-dealers, money managers, Congress and the Commission is the impact that competitive rates might have on services obtained by money managers from broker-dealers and the methods of paying for those services. Under present fixed rates, competition among broker-dealers for business has taken primarily the form of bundling various services, including research, within the charge for execution. Because the commission rates have been fixed, money managers have developed a course of dealing with those brokerage firms offering the most desirable services in order to maximize the benefits flowing from the total commission dollars paid. One of the most important brokerage related services utilized by money managers is research, and thus some brokerage firms have found it profitable to develop a strong research capability to attract customers.

On the basis of present practices, state laws have been enacted and regulations established setting limits on fees and administrative expenses that may be charged to trusts, estates and other investment accounts for money management services. Furthermore, fee schedules have been established in contractual relationships between money managers and their customers on the basis that research and other services would

be available to the money manager through the allocation of portfolio transaction brokerage commissions, and such fees may not be sufficient to pay for services other than execution and still provide a reasonable return to money managers. While some of these contractual relationships may be revised as underlying factors change, revisions require time and there are relationships, such as testamentary trusts, which may be extremely difficult and cumbersome to alter.

Some money managers have expressed concern that as fiduciaries they will be obligated under competitive rates to seek the lowest execution cost for portfolio transactions without regard to the additional services that might be obtained through paying a higher brokerage commission. I question seriously whether such an obligation is contemplated within the term fiduciary. In fact, it would seem to me that, if a fiduciary determines that paying a required differential in order to obtain services along with execution, instead of paying for them separately, is in the best interest of his customer, he could fulfill his duty to the customer only by "paying up" for that package of services.

Be that as it may, if money managers believe they would be subject to such liability they face a difficult dilemma, and, in the absence of legislation providing relief, acting on such a belief could cause serious disruptions in normal business dealings. Moreover, brokers and dealers also

need time to adjust their operations to the new competitive environment. Therefore, the Commission has supported legislation which would provide that money managers shall not be deemed to have breached a fiduciary duty solely through causing an account to pay a brokerage commission in excess of that charged by another broker or dealer, if the money manager determines in good faith that the commission charge is reasonable in relation to the value of the brokerage and research services in terms of either that particular transaction or his overall responsibilities with respect to accounts over which he has investment discretion.

When this amendment, which was approved by the Senate Committee on Banking, Housing and Urban Affairs last Friday and is scheduled to be acted on tomorrow by the Senate, becomes law, it will be clear that a money manager may pay a higher commission for a bundle of services than for bare execution and will be relieved from legal liability for not tracing the cost and benefit to each account under management. This is an important result, and I personally favor it as a temporary, interim expedient designed to be of assistance during what may be a relatively difficult adjustment period. However, it carries with it seeds which could grow into new "give up" and reciprocal arrangements and practices which could be detrimental to the securities markets.

The amendment contains a very important limitation which requires a good faith determination that charges are

reasonable in relation to services provided, and I can think of no better way to make such a determination than on the basis of choosing among alternative costs for comparable services when and as they become available. Furthermore, while such an amendment can relieve money managers of legal liability, no legislation can insulate or relieve a money manager from the relationship which he has with his customers. I believe that the ability to determine the cost of various services, purchased either separately or bundled together, will make it possible and necessary for a fiduciary to become more precise in meeting his fiduciary obligation because charges and services received will be more visible and more amenable to measurement, not only by the money manager, but also by the customer. The fact that the money manager's decisions and the available alternatives that could have been selected by the money manager will be more visible to customers, and thus more subject to their scrutiny, will provide a powerful incentive for a money manager to assure and be able to demonstrate that he is obtaining best execution and that all charges against a customer's account are reasonable and will provide meaningful benefits to that customer.

In my opinion, although fiduciary liability is an important consideration, it will not be the basic issue for reputable money managers. Perhaps the most important business asset a money manager possesses is the confidence and trust of his customers and their belief in his integrity. Under present

industry practices, most customers probably don't know, and in fact cannot ascertain, what proportion of the commissions they pay for portfolio transactions is used by their money manager for purposes which may be only remotely related, if at all, to their account.

Competitive rates will make it possible for money managers to show the separate costs for execution, research and other services, and I expect customers will desire an accounting of such costs if paid for through charges against their accounts. In order to obtain and retain customer confidence, I believe it will be in the money manager's interest and a good business decision to identify and disclose all services purchased for an account through an itemization of charges for those services, whether purchased separately or in a bundle. To provide anything less will expose the money manager to various adverse customer reactions which could be minimized, if not eliminated, through meaningful disclosure.

Having discussed in some detail the problems associated with charging customer's accounts with the costs of services other than execution of securities transactions, I would like to suggest a simple alternative method of operation which would appear to resolve most, if not all, of the problems which presently are of such concern to money managers. I personally believe that eventually most money managers will cover all charges for services, other than bare execution

charges, from revised money management fees, whether such services are provided internally by the money manager or purchased from external sources. Customers would focus only on two charges--the money management fee and the charge for execution, and money managers would be relieved of trying to explain why the customer is charged for research and other services when he is paying a fee to the money manager to manage his account.

Because costs for obtaining services would represent an expense to the money manager, it would be in his economic interest to consider carefully those costs and either obtain desired services at the lowest cost from others or develop an internal capability to provide the service. Thus, competitive forces would tend to assure that only needed services are produced and that charges for such services are reasonable. Money management fees would not be subject to reductions such as an off-set of brokerage produced by accounts under management because brokerage would provide only execution, and competition between money managers for customers would determine the reasonableness of money management fees.

It should be quite evident that I believe separate payments for services will be in the interest of money managers and their customers, but what about broker-dealers who have established their operations on the basic premise that competition would occur through offering services in

combination with execution of transactions for a fixed commission. We have seen recent evidence in the press that some broker-dealers do not intend to separate execution and research, and that some money managers intend to trade mostly with full service firms. I find no conflict with these stated intentions and what I expect to occur. Certainly on May 1, everyone isn't going to unbundle everything immediately and charge separately for all services. While some unbundling may occur on Mayday, changes resulting from competition will generally occur over a period of time.

No doubt there will be some brokers who will retain a combination of these two services, but they will do so in direct competition with firms which will offer execution only and others which will offer separate services. Whether research and execution are unbundled or not by all firms, purchasers of services will have unbundled alternatives to use as a yardstick of prices and value received and thus will make their decisions as to whether to obtain a bundle of services or to obtain them separately on the basis of which alternative provides the desired services for the lowest cost. In some instances, the cost of research may be insignificant, and, when spread over all of a broker's customers, it may be in the brokerage firm's economic interest as an advertising or a sales tool to include research without any increase in bare execution commission charges. In other instances, a full service firm may find

that the services it is offering provide the best package obtainable by some money managers at the price offered and thus such services will be in demand whether priced separately or in a bundle.

Although some broker-dealers view the prospect of unbundling and charging separately for services with apprehension, such a change can result instead in more accurate pricing, greater profits, increased stability of earnings, a stronger securities industry and a more efficient capital raising mechanism. It is somewhat surprising in this age of computers and sophisticated management techniques that many broker-dealers do not even claim to know the profitability of different segments of their business operations. Furthermore, without separate charges for services, it is unlikely that broker-dealers can appraise accurately the demand for various services.

There are indications that some of the brokerage services presently offered to customers for nothing are worth just that much to some customers; yet offering these services involves expenses for the broker-dealer. To continue to provide services which are not wanted or used is inefficient and reduces the profitability of individual broker-dealers as well as the securities industry as a whole. Careful analysis of the demand for services and the maximum profit margin which can be obtained by broker-dealers from these services can

occur only when customers are able to choose among alternatives on the basis of charges which are both cost and demand related. Under such conditions, the services offered and the prices charged for those services will reflect what they are worth to those by whom they are purchased. That is the essence of a free market economy, which, with some limitations, is the best mechanism known for allocating resources efficiently and minimizing government regulation.

While the transition to competitive commission rates undoubtedly will have a greater impact on the structure of our securities markets than any other single change, progress is being made also in other areas towards a more efficient and more responsive securities market system. Over the years, restrictive rules and practices, including fixed commission rates, have resulted in a market system where the flow of securities transactions has been fragmented into separate marketplaces, and, without a communications system which would interface these marketplaces, it is not possible for all bids for securities to be exposed to all offers. Steps now underway to interface these marketplaces into one national or central market system include the consolidated transaction tape to report all last sale transactions in eligible listed securities, a composite quotation system reflecting all current bids and offers in such securities, the establishment of depositories to immobilize stock certificates and perform transfers by

book entry, and arrangements between clearing agencies either to combine or to interface clearing operations.

Legislation now under consideration by both the House and Senate, which should be law before May 1, increases and clarifies the authority of the SEC and directs us to facilitate the establishment of a national market system. The legislation does not define all of the elements and characteristics of a national market system, but the system is to be established in accordance with Congressional findings and objectives which state that it is in the public interest to assure: economically efficient mechanisms for the execution of securities transactions; fair competition among brokers and dealers and among all markets; the availability of quotation and last sales information to industry participants and investors; and the practicability of executing orders in the best market. With such a directive from Congress and with competitive commission rates, you can expect to see the removal of other regulatory barriers to competition which are not necessary for fair and efficient markets and the establishment of communication systems to not only provide market information, but also to assure the practicability of best execution.

As the countdown to competitive rates continues, some have suggested that the introduction of competitive rates on May 1, will be a "non-event". If that term is used to suggest that there will not be massive defections from

exchanges, undesirable concentration in the securities industry, and a weakening of our capital raising mechanism, then indeed May 1 will be a "non-event." On the other hand, I believe anyone who may use the term to suggest that there will not be meaningful changes in the industry grossly underestimates the power of price competition and will be proved to be dead wrong.