PRICE COMPETITION ON THE NYSE

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UNTIL MAY 1975, the brokerage industry was among the most enduring of the world's cartels, having maintained a system of fixed commission rates since 1792. That cartel, existing under the auspices of the New York Stock Exchange (NYSE) with oversight by the Securities and Exchange Commission (SEC), maintained controls on both prices and entry. Prices, in the form of a complex schedule relating the commission charged to the price of the stock and the number of shares being traded, were set by the Board of Governors of the NYSE (elected for the most part by NYSE members) and ratified by the SEC. Membership in the New York Stock Exchange was limited, and new members could join only by purchasing memberships from departing firms and by meeting strict conditions laid down by the exchange.

Then—and now, of course—the NYSE was not the only stock exchange, and not all stock brokers were members. The largest of the competing exchanges was the American Stock Exchange (AMEX); in addition, there were "over-the-counter" markets for stocks not listed on the major exchanges. Brokers that were not members of the NYSE had to execute trades on the exchange through member brokers, at industry-regulated rates.

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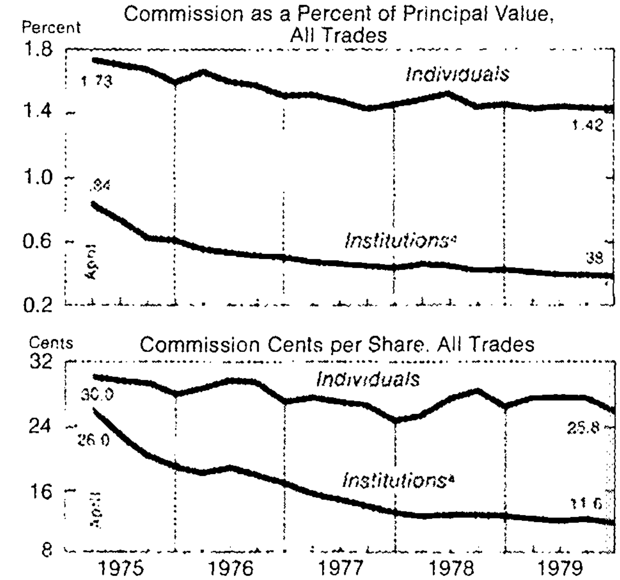
Analysts found that the brokerage cartel performed almost exactly as economic theory predicted: Unable to compete directly by offering reduced commissions, brokerage firms competed indirectly by offering a variety of services in addition to the simple execution of stock trades. Research services were the main "frill" offered, but plush "boardrooms," free selling of mutual funds, and indirect rebates known as "give-ups" were also common.

In 1968 the NYSE applied to the SEC for approval to raise its minimum commission schedule. The Department of Justice intervened, however, with a brief that raised the basic question—why was a fixed commission system needed at all? The outcome was a round of hearings and debates that led first to the end of mandatory fixed commissions on very large orders in 1968 and finally to the end of fixed rates altogether in May 1975.

Almost needless to say, the NYSE and its member brokers were adamantly opposed to price deregulation—at least its earliest phases. In 1968 the exchange made its own study of what such deregulation might do to the industry (*Economic Effects of Negotiated Rates on the Brokerage Industry, the Market for Corporate Securities and the Investing Public*). The study predicted that a shift to negotiated rates would lessen incentives for exchange membership, causing NYSE membership to decline. A greater percentage of trades would take place away from the NYSE floor, making it more difficult for the SEC to regulate the market. Price deregulation would also lead to cut-throat competition among brokers and increased industry concentration without increases in efficiency. Ancillary services such as market research would be eliminated.

Now more than five years have passed since the SEC ended the fixed commission system, easily enough time to begin to draw conclusions about the results. The studies completed to date, the most comprehensive of which are by the SEC itself, conclude that the deregulation has been successful. Here we analyze its effects on prices, profitability, and industry structure, finding that the market for securities trading in the United States has been improved—for consumers and the securities industry alike.*

Figure 1
EFFECTIVE COMMISSION RATES OF NYSE FIRMS, APRIL 1975 THROUGH 1979



a Where institutional and individual customers cannot be precisely identified, COD business is defined as institutional and all other business as individual.
Source: Securities and Exchange Commission, *Staff Report on the Securities Industry in 1979*, September 1980, p. 46.

Prices

That the fixed-rate system had produced excessive commission levels was evident immediately following the deregulation of commission rates in May 1975. In contrast to the series of commission rate increases that had characterized the late 1960s and early 1970s (the last of which took effect on April 1, 1974), the trend in commissions following deregulation was downward. The SEC's first report on the matter, issued in December 1975, noted that commission rates for institutions fell 26 percent between May and August 1975 when measured as a percent of principal (value of the shares traded), and 19 percent when measured by cents per share. Individual rates fell by lesser proportions—2.3 and 2.0 percent for the respective measures. Rates for all large-lot transactions, both individual and institutional, fell significantly, while commissions on small and odd-lot transactions rose marginally.

The SEC report also examined the effect of price deregulation on brokerage house revenues. The effect was estimated by calculating the amount of revenue that would have accrued to NYSE firms under the old fixed-rate schedule, assuming the same transactions as actually occurred under the new negotiated rates. By that measure, brokerage firms received $89.6 million less in the first *four months* following the deregulation than they would have under the old schedule. So in effect consumers of brokerage services saved nearly $90 million.

Perhaps more important, it is also clear that price freedom allowed brokers to give discounts for low-cost transactions involving large blocks of shares. According to the SEC's *Report on the Securities Industry in 1978:*

> The fixed rate schedule underestimated the fixed cost component and overestimated the variable cost component of the commission business. Abolition of the fixed rate schedule has resulted in a *restructuring of commission rates to bring them in line with actual costs.* [Emphasis added.]

In other words, competitive rates resulted in relatively lower prices for larger transactions. Consumers took advantage of the new rate structure by increasing the size of their transactions. The SEC found that the average individual order rose from 263 shares in April 1975 to 363 in December 1977, while the average institutional order rose from 1,141 shares to 1,572.

The decline in commission levels that characterized the first four months following the

*It should be noted that the 1975 deregulation affected commission rates only. The securities industry and the exchanges are still subject to extensive controls, including margin requirements, stock registration requirements, and a variety of entry limitations.

price deregulation continued for nearly three years. As Figure 1 indicates, between May 1975 and December 1977 commission rates for individuals fell 18.3 percent when measured in cents per share and 16.2 percent when measured as a percentage of principal value. By comparison, institutional rates fell 48.8 and 45.9 percent according to the same measures, respectively. The SEC estimated that price competition saved consumers of brokerage services nearly $700 million in the first twenty months following deregulation.

After 1977, commission rates generally leveled off. Looking again at Figure 1, rates charged by NYSE member firms (not adjusted for inflation) fell moderately for institutions and rose slightly for individuals in 1978 and 1979. An SEC analysis of that period showed that the "shaking out" process—the post-deregulation readjustment and search for equilibrium—was completed by 1978 *(Securities Industry in 1978)*. In other words, the market took a little over two years to reach a new equilibrium.

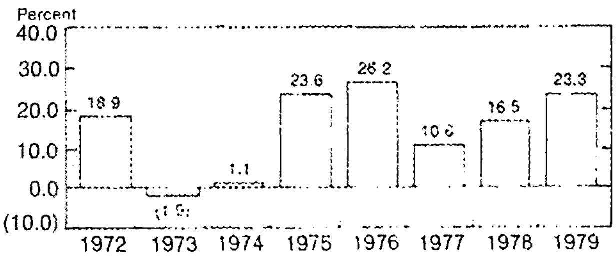
Profitability

As shown in Figure 2, NYSE firms operated unprofitably for the two years before deregulation, but turned in healthy profits for the years 1975–79. In the past, the revenues and profitability of the securities industry have been influenced more by the volume of stock trading than by any other single variable. This factor, along with the trend in stock prices (which also has a direct positive impact on industry profits), was largely responsible for the lack of profits in 1973 and 1974, and for high revenues and profitability in 1975 and 1976. In 1977, however, when market conditions deteriorated, industry profitability did not suffer badly. And in 1978, when market volume rebounded, profits did also (though not by comparable proportions, largely because of higher interest rates and hence higher interest expenses to brokerage firms). In 1979, another good year for the stock market generally, profits rose further by 61 percent.

While it is not possible to draw strong conclusions about the effects of deregulating commission rates on profits, it is clear that cost-based prices do not necessarily result in decreased profitability for an industry as a whole.

Figure 2

PRE-TAX RETURN ON CAPITAL, NYSE FIRMS DOING A PUBLIC BUSINESS, 1972–79



Note: Return on capital is defined as the ratio of income (after partners' compensation but before taxes) to total capital. Total capital is defined as the sum of ownership equity and subordinated borrowings.
Source: Securities and Exchange Commission, *Staff Report on the Securities Industry in 1979*, p. 39.

By eliminating "frills," diversifying, and restructuring, the securities industry has been able to earn very high profits even while receiving drastically lower prices for its primary output. The SEC has concluded, moreover, that diversification and pricing freedom have lessened the influence on profitability of cyclical changes in trading volume *(Securities Industry in 1978)*.

Industry Structure

Since 1975 the securities brokerage industry has undergone a substantial restructuring. On balance, however, this appears to have been beneficial.

The most publicized, if not the most important, change of this kind in the last decade has been a substantial increase in industry concentration. In response to general concern about that development, the SEC examined the relevant facts in some detail. It found that the percentage of total industry commissions accounted for by the top ten firms increased from 38.2 percent in the first quarter of 1975 to 45.9 percent in the final quarter of 1978. Concentration as measured by equity capital and other measures increased as well. However, the SEC noted, "the data suggest that the trend toward increased concentration began well before the introduction of negotiated rates in May of 1975. This suggestion, furthermore, is supported by our statistical analysis" *(Securities Industry in 1978)*. So, while the years following the deregulation of commission rates witnessed an increase in concentration, the increase was apparently not the result of deregulation. Indeed, the rate of increase seemed to slow after 1975.

To further investigate the extent of concentration in the brokerage industry, the SEC compiled lists of the top ten firms (measured by commission income, underwriting income, gross revenue, and equity capital) for each of the years 1972–78. Mobility in and out of the top ten has been extensive, and firms that ranked as low as twenty-sixth in 1972 were in the top ten by 1978.

Some observers argue that increased concentration results from increased returns to scale—that is, larger firms have cost advantages not available to smaller firms and thus are able, over time, to increase their shares of the market. SEC studies indicate that this has not been the case in the securities brokerage industry. Comparing firm profitability and firm size in 1977, 1978, and 1979, the SEC found no significant correlation; in fact, to the extent that any discernible correlation existed, it appeared to be negative *(Securities Industry in 1979)*.

Much of the concern over brokerage industry concentration resulted from the highly publicized increase in mergers that occurred following deregulation. That increase, it appears, was largely a manifestation of the attempts of firms to restructure their operations to meet new market conditions. For example, firms that relied heavily on institutional customers before 1975 found themselves facing vastly different conditions thereafter. Comparing the months before deregulation with 1976, while NYSE firms in the aggregate experienced a fall in average monthly commission revenues of only 1 percent, firms classified by the SEC as "institutional" experienced a 20 percent decline. The SEC concluded that the revenue loss to institutional firms in 1975 and 1976 "caused several small institutional broker-dealers to leave the securities business or to merge with larger retail-oriented broker-dealers" (*The Effect of the Absence of Fixed Rates of Commission*, January 1977).

While the bulk of the industry has diversified into such areas as trading, financial planning, and insurance, so as to become less dependent on commissions, an entire new segment has emerged that depends almost entirely on commission revenue. Before 1975 there were, according to the SEC, only a "handful" of so-called discount brokerage houses, offering brokerage services at below-market rates. Because the rates on the NYSE floor were fixed, these houses traded almost exclusively in over-the-counter stocks. Since 1975, however, discount brokers have become a major force in the industry, either negotiating arrangements with NYSE members to make NYSE transactions for them at a reduced rate or becoming NYSE members themselves. These firms offer a price-quality option not previously available—no-frills service at a low price. Generally, they do business over the telephone, do not offer the research services provided by the "full-line" brokerage houses, and maintain less excess capacity than other firms. According to the latest SEC data, there are now ninety-seven discount brokers, accounting for nearly 8 percent of the total retail market. The SEC has found that the discount brokers consistently outperformed other NYSE member firms in terms of profitability *(Securities Industry in 1979)*.

Conclusions

In summary, price deregulation in the securities brokerage industry has brought lower prices for most classes of service and a greater array of price-quality options, without having significant adverse effects on the industry. It is important to note, however, that these benefits have come about even though the industry is still heavily regulated. For example, entry into the NYSE is still limited. While the price of seats on the NYSE did drop somewhat following the breakup of the price cartel, it has since risen above pre-1975 levels. Moreover, the NYSE's qualification requirements for membership (character, financial standards, and so on) still exist. Nevertheless, the experience of the discount brokers—firms that began as non-NYSE members bargaining for access to the exchange through NYSE member firms—indicates that significant benefits can accrue even in the presence of qualification requirements and limitations on direct access to the market.

Steps towards deregulating prices have now been taken in airlines, communications, railroads, and trucking, as well as in securities brokerage. In each case, advocates of deregulation predicted lower prices for consumers without disastrous effects on industry profits or structure. The example of the securities brokerage industry appears to support those claims. ■