Submission by

The Director of Investigation and Research

Combines Investigation Act

To The Ontario Securities Commission

Regarding Fixed Commission Rates

On The Toronto Stock Exchange

July 19, 1976

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Interest of the Director of Investigation and Research

The responsibilities of the Director of Investigation and Research, Combines Investigation Act, include the enforcement of that Act as well as the promotion of competitive policies which underly the Act. The Director's interest in this hearing stems from both of these responsibilities.

The recently enacted amendments to the Combines Investigation Act extend its coverage to include the services industries for the first time. Therefore the activities of the securities industry, at least potentially, are subject to the provisions of the Combines Act. There have been a few cases under the Combines Act which provide an exemption for regulated activities from the Act in certain circumstances. However the precise relationship between regulated activities and the Combines Act is by no means certain. The Director's interpretation of the Act in this respect is that those activities which are subject to regulation by a public authority, acting under valid and specific legislation are exempt, if the activity is effectively regulated and the regulation covers such matters and is for such purposes as to make the application of the Combines Act incongruous.

This hearing, to determine whether fixed commission rates as set by the Ontario Securities Commission are to pertain in the securities industries in Ontario, is an important one for the Office of the Director of Investigation and Research. This is so because it directly affects the scope and circumference of his law enforcement responsibilities.

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As regards the Director's responsibilities to promote competitive principles contained in the Combines Act, the recent amendments to the Act gave him the power to intervene before federal boards and tribunals where matters of competition are in issue. Of course, the legislation did not grant him the right to appear before provincial regulatory tribunals. However neither did it preclude him from so appearing where such an appearance could be of material aid to a provincial agency.

Because of the importance of the issue before this Commission and its direct affect on the Director's responsibilities, it was felt desirable to make the Director's views clear to the Commission at its hearings. There is no intention, however, to judge the issues arising before the Commission or to recommend a particular course of action which the Commission might follow in disposing of the matter. Also, for various reasons this submission includes no new empirical studies of the securities industry. Essentially the Director's comments will put before the Commission his view of the issues and arguments which are likely to be advanced in favour and against fixed commission rates. As the hearing proceeds, the Office of the Director will be reviewing the briefs and comments of other parties to the proceedings, and as a result of that review may wish to make additional comments when appearing directly before the Commission.

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INTRODUCTION

This submission is divided into two major parts. Part I describes the inherent advantages of a competitive free market system and some of the difficulties encountered with the regulatory alternative. This Part deals with general principles supplemented, where appropriate, with specific examples of difficulties in regulating commission rates in the securities industry. The purpose in this Part is to demonstrate that, in general, regulatory schemes are inferior to freely competitive markets.

Part II turns to some of the arguments advanced in favour of fixed commission rates which would suggest that the general presumption in favour of free competition is inapplicable to the brokerage industry.

GENERAL PRINCIPLES FAVOURING COMPETITION

Presumption in favour of competition; resource allocation and efficiency

It is a fundamental tenet of competition policy that over the greater part of the economy, competitive market forces are capable of allocating resources better and more cheaply than any alternative arrangement.[1] In some situations (natural monopoly is an obvious example) some other arrangement is more suitable, but, as a general rule, the advantages of a competitive market structure are well recognized. This recognition is reflected in the ongoing amendments to the Combines Investigation Act and, in particular, the extension of the application of that Act to services, effective July 1976.

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[1] Economic Council of Canada, Interim Report on Competition Policy 8 (1969)

It has been argued that since there is no clamour for change the status quo must be satisfactory. Supporters of fixed rates, for example, have pointed out that in Ontario the initiative regarding unfixing of rates has been taken by the Commission. It should be noted, however, that with the introduction of competitive rates above $500,000 the criticism of those most seriously affected may have been stilled. Perhaps more important, the benefits of a competitive regime are likely to be the diffused among numerous unorganised individuals, each with an insufficient stake in the outcome to merit active advocacy. For example, the ultimate beneficiary of negotiated commission rates might be the small investor who places his funds with a financial institution, if institutions, as predicted, pay significantly lower commissions under a negotiated commission structure.

Competition encourages proper allocation of resources and is a vital element in creating an efficient industry. In a freely competitive market place efficient firms prosper and grow while inefficient firms wither and die. Efficient firms are better able to attract capital and thus economic resources are directed to those best able to use them.

The extent to which inefficiency exists in the Canadian securities industry is hard to measure. A recent studdy which throws light on this subject is that by David Shaw and Ross Archibald (sponsored by the Toronto Stock Exchange). They observed an absence of management controls and lack of planning in the

securities industry.[2] They found that the third most important problem perceived by industry executives was the fact that there were too many securities firms being poorly managed.[3] Ross and Archibald concluded that:

> "...the fixed commission structure is a factor which has affected the development of many securities firms. The pricing of services by individual firms operating in a competitive environment provides a major efficiency check on any system. The fact that securities firms compete vigorously, but not on the basis of price, has resulted in inefficiencies within firms and the relative lack of management expertise which we and other industry respondents observed in many firms."[4]

Attempts to bypass fixed rates, service inflation

Under a freely competitive system prices are set where price equals marginal cost. Where an artificial, fixed price is set higher than the marginal cost of some firms, one of two things is likely to occur as those firms reach out for business.

One possibility is that the broker and his client will cooperate circumvent the fixed price. "Give ups" and "reciprocal deals" were well documented on the N.Y.S.E when it operated under fixed commission rates.[5] According to a recent press report[6] the

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[2] Shaw, David C., and Archibald, T. Ross, The Management of Change in the Canadian Securities Industry, Study Seven, "The Securities Firm in the Canadian Capital Market" 106 (1976).

[3] Id., at 103.

[4] Id. at 107

[5] Kahn, Alfred E., The Economics of Regulation: Principles and Institutions, Volume 2 at 207 (1971)
Mann, H. Michael, The New York Stock Exchange: A Cartel at the End of Its Reign", in Promoting Competition in Regulated Markets, Almarin Phillips, editor, 305, 314 (1971).

[6] Financial Times of Canada, June 14, 1976, "Cross-border stock trades investigated: millions in kickbacks possible".

O.S.C. has recently investigated an elaborate cross-border kick-back arrangement, between a Toronto based financial institution and Canadian and U.S. brokers, which allegedly involved millions of dollars in commissions. Trading interlisted stocks on the N.Y.S.E. where rates are unfixed is an obvious way of avoiding higher fixed rates on the T.S.E., provided other costs of trading in New York (such as, perhaps, those resulting from a thinner market) are not prohibitive.

The other possibility is that firms, denied the ability to reach out for additional business by price reductions, will do so by providing "free" services of one kind or another. The customer who wants to buy execution of orders plus salesmanship, advice, and research pays the same price as the customer who wants only execution. The consequence is an inherent tendency to what has been termed "service inflation" in which equilibrium of cost and price is achieved, not by reducing price to marginal cost, but by raising marginal cost to price.[7]

There is of course no guarantee that the value to clients of the "free" services provided will be equal to their cost to the firm. There is also no guarantee that any service or rebate scheme will benefit the ultimate client and not the financial intermediary. If the broker has excess revenue which he is willing to rebate in order to increase his business, it is a matter of indifference to him whether this rebate goes to the ultimate client (as it would with a reduced commission rebate) or to the intermediary (as it might in the form of hockey tickets or services).

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[7] Kahn, _supra_ note 5 at 207.

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Service inflation is part of a vicious circle in its continuous upward pressure on the commission rate structure. "The dynamics of service competition in the securities industry guarantees that costs will build up rapidly until they exhaust whatever revenues are produced by a given rate structure - thus any rate schedule becomes self-justifying on a cost basis over time."[8]

The regulator can be forced into attempting to regulate quality as well as price. As Kahn put it, it will be futile to affix a minimum price for a dozen rolls if bakers remain free to decide how many rolls constitute a dozen.[9] Thus regulation begets more regulation as the ingenious search for and find alternative modes of competition. The regulator can become engaged in an endless exercise; when he pinches the balloon in one place, it bulges in another.

As examples of the tendency to service inflation and regulators' attempts to control it, we would cite the T.S.E. bylaw definition of nine areas in which brokers may earn commission dollars and the November 1975 and March 1976 Exchange directives on this issue,[9A] (apparently in response to one firm's provision of sophisticated portfolio measurement services for "soft" commission dollars).

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8 Testimony of Donald Farrar, Director of the SEC's Institutional Investor Study, quoted in the Securities Industry Study, Report of the Subcommittee on Securities of the Senate Committee on Banking Housing and Urban Affairs, S. Doc. No. 93-13, 93d Cong., 1st Sess. 46 (April 6, 1973).

9 Kahn, supra note 5 at 210.

9A "TSE defines broker services", Financial Times, Nov. 17, 1975; "Portfolio measurement declared unacceptable soft-dollar service", Globe and Mail, Dec. 19, 1975; "TSE to review broker services", March 29, 1976.

Problems with the regulatory alternative

The Ontario Securities Commission has a legislative mandate to regulate the Toronto Stock Exchange in the public interest.[10] In our view the key issue at this hearing is whether it is necessary for the Commission, in carrying out its mandate

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[10] See s. 140 of the Securities Act, R.S.O. 1970 as amended 1971 c. 31, 1973 c. 11:

> (1) No person or company shall carry on business as a stock exchange in Ontario unless such stock exchange is recognized in writing as such by the Commission.
>
> (2) The Commission may, where it appears to it to be in the public interest, make any direction, order, determination or ruling,
>
> (a) with respect to the manner in which any stock exchange in Ontario carries on business;
>
> (b) with respect to any by-law, ruling, instruction or regulation of any such stock exchange;
>
> (c) with respect to trading on or through the facilities of any such stock exchange or with respect to any security listed and posted for trading on any such stock exchange; or
>
> (d) to ensure that companies whose securities are listed and posted for trading on any such stock exchange comply with this Act and the regulations.

to protect the public interest, to extend its regulatory power to the fixing (or approving) of minimum commission rates. Part II of this brief deals with those arguments which suggest that fixed rates are necessary and which therefore imply that the Commission's regulatory role includes rate-fixing. We summarise here some of the serious difficulties involved with such a conclusion, difficulties which, we submit, should be weighed in the balance when deciding whether or not rates should be regulated or set by free market forces.

One problem with regulation has already been discussed. Regulation begets more regulation. The fixing of prices leads towards detailed definition by regulation of the package or bundle of services to be provided.

A second problem with regulation is that it is a poor substitute for competition. Competition both pulls and pushes; it rewards the efficient and penalises the inefficient. Regulation is more like a string. One can pull, but one cannot push on a string. Efficiency and good management cannot be created by regulatory fiat.[11]

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[11] This limitation of regulation was recently spelled out by Aflred Kahn, author on the subject of regulated industries, and currently chairman of the State of New York Public Service Commission:

> "The sources of initiative are in the hands of management - a management insulated from the discipline and prodding of competition. The authority of the regulator is essentially negative: it can check the exercise of private monopoly power, it can limit prices and profits, it can occasionally disapprove a wasteful expenditure. It can cajole, and, within very

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A third problem is a practical one. How can a regulatory body arrive at the correct commission rate? How can it decide which services should be included in the commission bundle and which should not? Acquisition of detailed cost data (itself a major undertaking) is only the beginning of the problem. The inextricably intertwined nature of the brokerage, underwriting, margin, investment advisory and other services provided by broker-dealers creates immense difficulties in allocating costs, capital and revenues among these functions. Furthermore, the industry is characterised by the diversity of firms which engage in different mixes of business. A rate schedule, or services directive, inevitably favours some firms over others. Where are the objective standards that a regulator might apply? In the absence of objective standards, where are the equitable criteria?

A fourth problem is cost and delay. Acquisition of the data on which to base a decision is itself costly. To this must be added the cost in time and effort of regulators and regulated industries trying to understand and manipulate the raw data and to persuade each other of its meaning and implications.

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11 Cont'd narrow limits, offer rewards and threaten penalties. But the limits are very narrow and the role of the regulator therefore remains essentially passive and reactive. A regulatory commission cannot take initiatives in the market itself; it has no capital of its own to risk. It cannot force a company to be progressive, to innovate, to be efficient. It cannot do what good management can do, and there is very little it can do about what poor management do."

Letter (Feb. 9, 1976) of Alfred Kahn to Senator Kennedy, in Hearings on S. 2028 before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary 94th Cong., 1st Sess. at 586-7 (1976).

Delay is so closely related to the whole process of rate-fixing that the phrase "regulatory lag" is now in common usage. The history of fixed prices in almost any economic activity is that they are not changed when the conditions under which they developed change. Frequently the complainants are the regulated who claim that costs have risen without offsetting price increases. An interesting twist occurred in December 1973 when the T.S.E. applied for an extension of the temporary 10% surcharge. The chairman of the O.S.C. was reported[12] as saying that if he had known that the industry's return on capital had risen during the period ended March he would have stopped the surcharge six months earlier. Flexibility to adjust prices is especially important if the business is cyclical or volatile.

A fifth problem with regulation, particularly in the setting of prices, is an inherent tendency to protectionism on the part of the regulating body. This tendency is too often commented upon to be ignored.[13] When some thoroughly disruptive innovation is threatened the almost inevitable regulatory temptation is to delay and compromise in the hope of treating all the affected interests "equitably".

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[12] Financial Times of Canada, December 8, 1975, "Some claim OSC ruling ruinous".

[13] See, for example, Kahn, supra note 5, at 12-13; and supra note 11 at 587:

> Regulation has inherent, and in my judgement inescapable tendencies to protectionism and cartelization.... The fundamental reason, I believe, is that regulation rests a very heavy responsibility in the regulatory commission for the continuity and quality of supply, and this engenders inescapably a solicitude for the financial health and stability of the regulated companies. In the competitive market, in a sense no individual or company bears this kind of direct responsibility for industrial performance. The continued service of the consumer is assured, rather, by the processes of competition themselves.

This problem is compounded by the imbalance of information and persuasion pressed upon the regulator. The regulated are those people to whom the regulator is exposed on a constant and continuing basis. Their individual stake in regulatory decisions is far greater than that of the consumers of their services. The interests of consumers are far more diffused and therefore tend to be inadequately represented. The not-surprising result is that regulatory decisions tend to protect the regulated.

The United States Council of Economic Advisers recognised the same problem in their 1970 Report:

> Change of any kind becomes hard to justify and even harder to allow when some affected group can claim immediate harm, whereas the potential beneficiaries are widely diffused and usually not representative. Yet innovation and adaptation are the dynamics of economic progress.[14]

The O.S.C. as rate setter

Both the O.S.C. and the T.S.E. have recognised that there are problems with regulation. The Commission has stated "we are not nor should we attempt to become a rate setting or approving body such as the various Energy Boards or Transport Commissions".[15] This view was wholeheartedly endorsed by the T.S.E. in August 1973 press release:

> The Exchange concurs in the statement of the Commission that the Commission is not nor should

[14] Council of Economic Advisers Annual Report, in Economic Report of the President 107-108 (1970).

[15] "Decision of the Commission in the Matter of Proposed Amendments to Part XV of the bylaws of the Toronto Stock Exchange" Bulletin of O.S.C. for August 1973 107, 113.

> it attempt to become a rate setting body such as the various Energy Boards or Transport Commissions. An industry with as many varied participants involved in various activities and with widely fluctuating volumes of business is not adaptable to such rate setting. Consequently, cost studies may be of assistance but can never be conclusive evidence of the appropriateness of a rate structure in the securities business. A difficulty with all cost studies is that they relate to past data. In any rate study procedure there is what is termed regulatory lag. This is particularly significant in an industry as volatile as the securities industry.... There is a very real danger that any public utility rate regulation would impose on the industry a commission structure appropriate to the past but completely unsuited to the existing conditions.[16]

We agree with these views of the Toronto Stock Exchange. They make a persuasive case for allowing free market forces to set commission rates.

In view of the problems we have noted we readily understand the Commission's reluctance to become a rate-setting body. However we are not convinced that the Commission can avoid this responsibility if it endorses the principle of fixed rates. The fixing of minimum commission rates by the Toronto Stock Exchange is, in effect, an exercise of self-regulation by a cartel. (Furthermore, this action, in the absence of proper legislative or regulatory approval, would be in violation of the Combines Investigation Act.) If this practice continues it is difficult to see how the Commission can avoid detailed investigation, amounting to rate setting, to ensure that the public interest is being protected.

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[16] Toronto Stock Exchange, release No. 73021, August 9, 1973

SPECIFIC ARGUMENTS SUPPORTING FIXED COMMISSION RATES

Framework for analysis: two markets

The preceding Part described various factors which suggest that, absent compelling reasons to the contrary, competition rather than regulation is the best way to set prices for brokerage services. It helps the analysis of arguments to the contrary if it is clearly understood at the outset that two different, though intertwined, markets are involved. The market to which Part I of this submission primarily relates is the market for brokerage services where the buyers are the institutional or individual traders and the sellers are the brokerage firms. The other quite different market is the market for equity securities (capital market).

If the capital market is to provide accurate signals for resource allocation, security prices must reflect available information regarding risk and return. Allocational efficiency is the term used to describe the extent to which the capital market achieves this function. However, it is obvious that to participate in the capital market buyers and sellers of securities incur transactions costs, including the bid ask spread and brokerage commissions. Operational efficiency in the brokerage service market is maximised when transactions costs are minimixed.

It is necessary when analysing the arguments for and against fixed commission rates to appreciate whether they deal with operational efficiency in the brokerage service market or allocational efficiency in the capital market. At the level of operational efficiency, supporters of fixed rates argue that the

market for brokerage services will not be improved by competition. A principal argument in this group is that this market is prone to destructive competition. Whether economic conditions in the brokerage industry justify this fear is open to serious question. Another argument in this group appears to treat the status quo as optimal by insisting in effect that the current level of services is perfectly adequate and therefore no change is necessary. The weakness of this approach is its failure to confront the fundamental thrust of the case for competitive rates, namely that even if services are adequate now they might well be better and cheaper in a competitive environment.

At the level of allocational efficiency supporters of fixed rates argue that a shift to competition in the market for brokerage services will have seriously harmful side-effects on the capital market. These arguments are premised on a prediction that competitive commission rates will lead to a significantly greater institutional role in the market and on an assessment that this is undesirable. Both premises, particularly the first, deserve close scrutiny.

Elimination of some firms

It is generally agreed that the effect of eliminating fixed commission rates will be a substantial reduction in the commissions paid on large orders (primarily by institutions) and a consequent reduction in overall commission revenue to the industry.[17] The major impact is expected to be felt by the

[17] See for example, Toronto Stock Exchange Commission Rate Committee, Paper No. 3 "Consensus of View of the Commission Rate Committee as to the likely consequences of a move to unfixed commission rates in Canada" (February 3, 1976).

so-called "B" firms catering primarily to institutional clients. It has been predicted that about eight of the sixteen existing firms in this category would be forced to close their doors.[18]

Much of the argument supporting fixed rates comes very close to saying that any absolute decline in the number of firms and/or personnel in the Canadian securities business would be detrimental to the proper functioning of the capital markets. It is submitted that any such assumption is unwarranted. Fixed rates should be eliminated precisely because they protect inefficient firms and foster economically unwarranted services. The logical consequence is that, under a competitive system, firms and services which cannot be economically justified will have to change or disappear. In our view there is no evidence that the current number of firms and personnel is optimal.[19] We have cited the Shaw and Archibald study which suggests the contrary.[20] T.S.E. membership has declined from a high of 100 in 1969 to 91 in December 1973, to 76 currently, apparently with no calamitous effect. We wonder whether, if this hearing had

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[18] Id., at 2

[19] Two crude measures used by the T.S.E. Commission Rate Committee comparing Canadian with U.S. data indicate that the appropriate number of members on the T.S.E. might be 46 (based on number of share owners in the population) or 21 (based on corporate stock outstanding as a percentage of G.N.P.). These are very rough calculations and are cited here only to indicate that the number of firms currently existing (under the protection of fixed rates) is not necessarily the optimal number. See Toronto Stock Exchange Commission Rate Committee, Paper No. 2, "The Impact of unfixed commission rates in Canada", position paper supporting negotiated rates, Appendix II (February 3, 1976).

[20] _Supra_ note 3.

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been held in 1973, 91 would have been defended as the optimal number of firms in the industry. It may be that there comes a point where concentration in an industry becomes so great that the forces of competition are weakened. However supporters of fixed rates generally fail to present convincing evidence that that point has or will be reached. There is therefore no evidence that the operational efficiency of the market will be harmed by the elimination of some firms.

"Destructive" competition and predatory pricing

Some supporters of fixed rates have argued that unfixing rates will unleash a wave of "destructive" competition. The generally accepted structural characteristics of industries where destructive competition is likely include a high ratio of fixed to variable costs, sharply fluctuating demand and ease of entry (e.g. farming). Supporters of fixed rates often fail to present persuasive evidence that the key economic conditions for destructive competition exist in the brokerage industry. Such economic studies as have been done in the U.S. lead to the conclusion that these conditions are absent.[21] There is no clear evidence that the situation in Canada is different. Experience on the N.Y.S.E. since May 1975 does not support the same fears

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[21] See Wallich, Demsetz, Baumol, Samuelson, R. West and Saha Tinic, William F. Baxter and Donald Baker cited in the Statement of Donald I. Baker, Director, Policy Planning, Antiturst Division, Dept. of Justice in Study of the Securities Industry, Part 8, Hearings before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, Serial No. 92-37g, 92d Cong., 2d Sess. 4120.

See also Friend and Blume, "The Consequences of Competitive Commissions on the N.Y.S.E."(April 1972) and H. Michael Mann *supra* note 5 at 306ff.

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expressed there that destructive competition would occur.[22]

Another argument suggests that predatory pricing will take place if rates are not fixed. However, to accept the argument that any firm will deliberately incur temporary losses in a predatory campaign it must be shown that the firm can anticipate ultimately reaping additional profits when its competitors have been driven out of the industry. It is generally unlikely that any firm will incur the costs of driving its competitors from the industry if they can return when monopoly prices are charged. This argument therefore fails unless barriers to entry can be erected.

The economic evidence from the United States does not show that there is a significant relationship between the size and efficiency of securities firms.[23] There is no evidence that the situation is different in Canada or that barriers to entry into the industry are high.

To achieve the economic power to reap monopoly profits, a very large proportion of the existing 76 member firms would have to be eliminated. We would add that predatory pricing is prohibited by section 34(1)(c) of the Combines Investigation Act.

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[22] See Securities and Exchange Commission, Second Report to Congress on the Effect of the Absence of Fixed Rates of Commission (March 29, 1976).

[23] Perhaps the best known is the 1968 Garil study which found that 70 N.Y.S.E. firms, including 40 in the smallest category, were more efficient than Merril Lynch, the industry's largest firm, cited by Baker, _supra_. note 21 at 4120. The more recent study by Friend and Blume, _supra_. note 21 came to the conclusion that "economies of scale in the brokerage business do not seem to be very strong."

Independents and Institutions - is change undesirable?

A major concern expressed by advocates of fixed rates involves the role of the independent investor in the capital market. The argument has two parts: first, that the introduction of competitive commission rates will favour institutions in the capital market; second, that this is undesirable. In this section we examine the reasons for opposing greater institutionalisation of the market and in the next section we shall examine the arguments predicting that it will in fact occur.

There are basically two levels of argument regarding the desirability of treating the independent investor favourably in charging commissions. The first level is concerned with notions of distribution of income and, sometimes, unclear references to "equitableness". The second level of argument is concerned with the quality and structure of the capital market and the effect of competitive rates on allocational efficiency.

According to the first level of argument the independent investor is to be treated favourably as a matter of public policy to encourage wide distribution of share ownership. In fact the Exchange has no mandate to redistribute income to "small" investors from the institutions. Perhaps more important, the truly "small" investor in our society is more likely to have invested his funds with an institution by way of a pension, retirement or insurance plan. The independent investor who regularly calls his broker to make trades (and that is the investor in whom the broker is interested) is unlikely to belong

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to a segment of society which is in dire need of economic assistance.[24]

It is sometimes argued that "equitable" treatment of the small investor requires the maintenance of fixed commission rates. Those supporting this position frequently point to the substantial reduction in the commissions paid by institutions on the N.Y.S.E. since May 1975. The fallacy of this reasoning is the one common to many of the arguments in favour of fixed rates - it starts with the premise that the status quo is optimal. In fact the current rate structure is distorted. Institutional rates are fixed artificially high. Institutions are discriminated against <u>now</u>. A correction of this distortion can hardly be called "discrimination" against the independent investor.

"One of the most absurd arguments I know is that the present structure is justified because it subsidizes the small investor by charging excessive fees to large ones. I never heard of anyone who has the effrontery to argue that an appropriate way to redistribute wealth is through the noneconomic pricing of brokerage services. And even if that were a conceivable way to do it, there is no clear evidence that the wealth that would be redistributed would be from the rich to the poor, since many of those who invest in institutions are the relatively poor."

Testimony of James Lorie, quoted in Securities Industry Study Report, <u>supra</u> note 8 at 60.

Some Canadian supporters [25] of the discrimination argument appear to have been misled by figures from the N.Y.S.E. which on a percentage basis, and in aggregate, show individuals paying significantly higher commissions than institutions. In fact "percentage of principal value" figures are misleading because institutions make larger trades. Since the absolute cost of executing a large order is not much more than the absolute cost of a small order, the commission charged, as a percentage of the value of the order, should be a great deal less. (Even when broken down by order size category the "percent of principal value" data is biased by the higher average price of shares purchased by institutions). As for "commission cents per share" data, this is also misleading when read only as an aggregate of all trades, again because institutional trades, in aggregate are on average for much larger orders. It is only when the aggregate figures are broken down into categories by size of order that more realistic comparisons can be made.

We have enclosed as Exhibit I an exhibit from the S.E.C. Second Report to Congress (dated March 29, 1976) covering the period May - December, 1975 which shows that in May, 1975 "commission cents per share" were much lower for

[25] See for example, Toronto Stock Exchange, Commission Rate Committee, Paper No. 1, "The Applicability of Unfixed Commission Rates in Canada", position paper supporting the maintenance of fixed rates, at 8, 9 and Appendix (Feb. 3. 1976).

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individuals than for institutions and that, despite an equalizing decline by institutional commissions throughout the year, the "commission cents per share" was lower for individuals than for institutions for each order size category in December 1975. (To demonstrate the misleading effect of aggregate and percentage calculations we attach as Exhibit 2 an exhibit from the same S.E.C. report based on the same data for the same period).

It should be noted that there has been no significant increase in commissions for individual investors on the N.Y.S.E. since May 1975. See Exhibit I.

At a more sophisticated level, those favouring the independent investor reason that his participation in the market is to be actively solicited in order to preserve the efficacy of the agency auction market and particularly to provide a market for the shares of smaller companies. Even accepting that the participation of the small independent investor is desirable for these reasons, we would seriously question whether cross-subsidization of commission rates is a desirable means of achieving this goal.

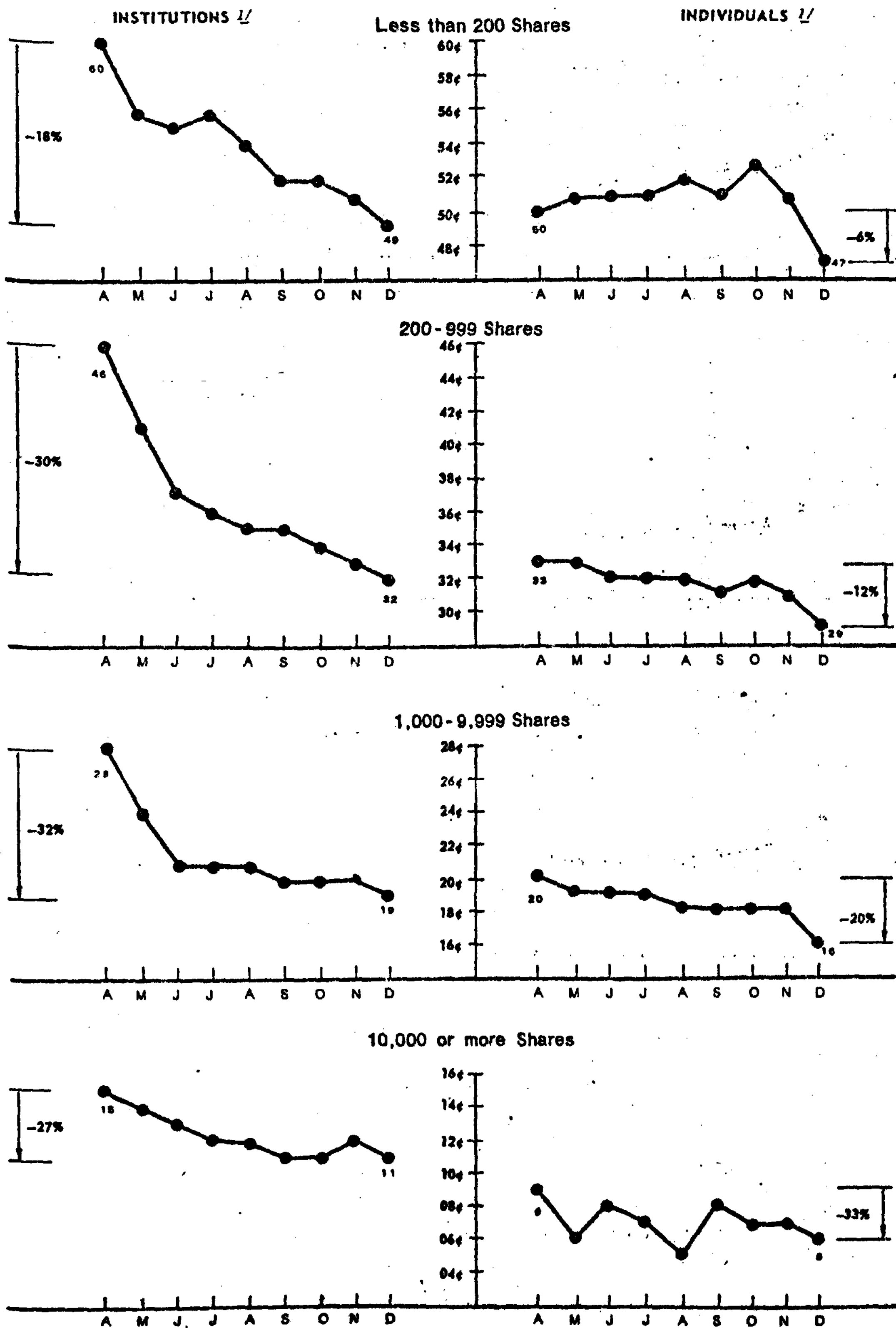
It is by no means obvious that a more liquid market for small companies ought to be preserved at the expense of the institutional investor. Reference to large institutions tends to obscure the point that the ultimate beneficiary of lower institutional rates is likely to be the relatively small investor who places his capital with an institution. Should such investors pay premium commissions to subsidize the independent investor? If basic economic forces suggest that the most efficient way of allocating resources in the economy is via institutions, are the efficiencies lost by artificially hindering this process more than offset by the economic gains resulting from the alleged greater liquidity provided by independent investors?

EXHIBIT I

EFFECTIVE COMMISSION RATES SINCE APRIL 1975

NYSE MEMBER FIRMS-COMMISSION ¢ PER SHARE

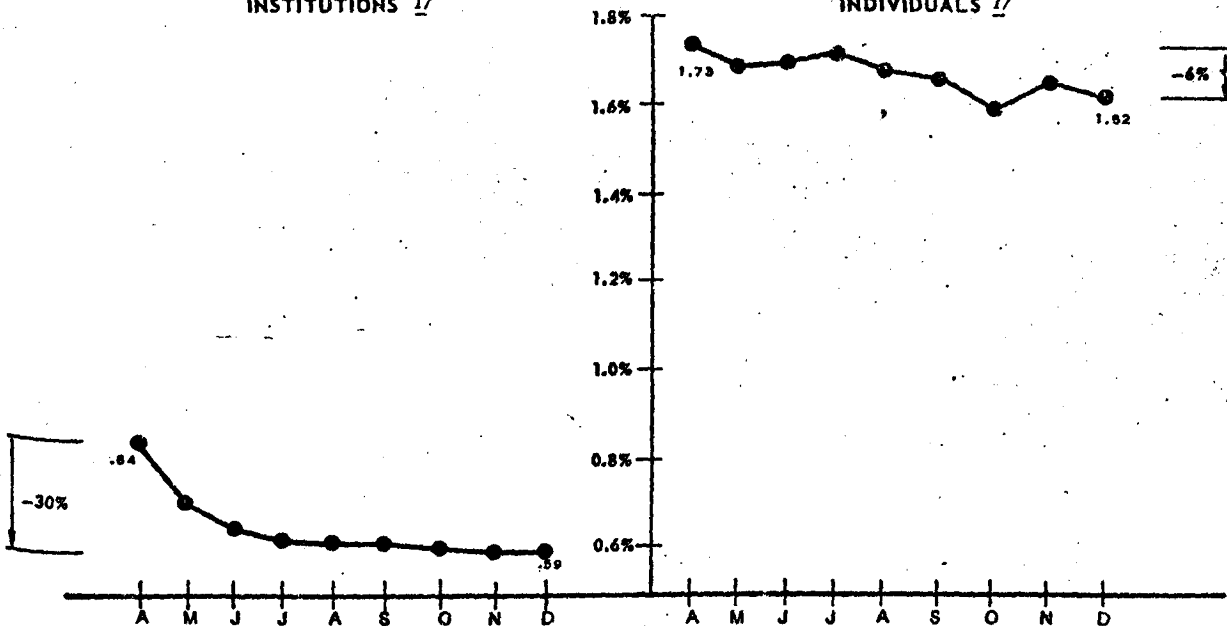
COMMISSION ¢ PER SHARE 1/

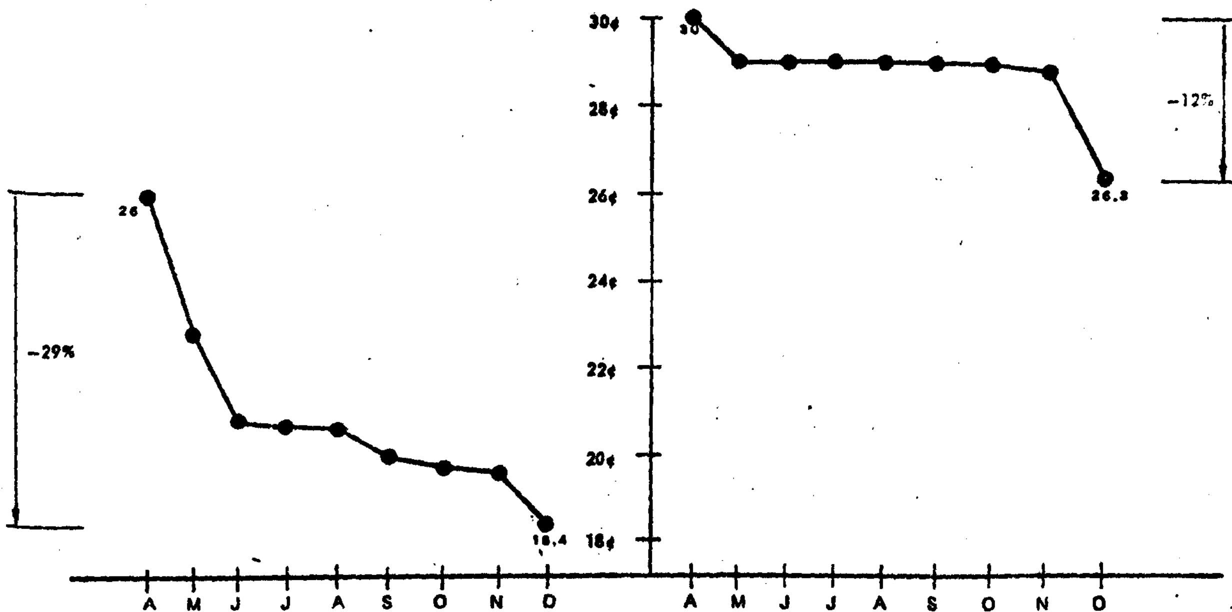


Source: Securities and Exchange Commission, Second Report to Congress on the Effect of the Absence of Fixed Rates of Commissions (March 29, 1976) at 19.

EXHIBIT 2

EFFECTIVE COMMISSION RATES SINCE APRIL 1975
NYSE MEMBER FIRMS–OVERALL





Source: Securities and Exchange Commission, Second Report to Congress on the Effect of the Absence of Fixed Rates of Commissions (March 29, 1976) at 16.

Independents and Institutions - will significant change occur?

A major fear expressed by supporters of fixed rates is that under competitive rates in the market for brokerage services the allocational efficiency of the capital market will be impaired. This impairment is premised on a belief that the role of institutions in the trading of securities will increase at the expense of independent investors. Two reasons which have been advanced to substantiate this belief are the reduced commissions which institutions are expected to pay under a competitive system and the reduced research which will be done if some firms and analysts leave the industry.

As regards the effect of reduced commissions charged to institutions, it is clear that this reduction will change the relative transaction costs of individual and institutional investment in favour of the latter. However proponents of fixed rates have failed to do more than demonstrate the direction of this change. The more important question is the significance of this marginal change in transaction costs for the investment decision of the individual investor. Advocates of fixed rates have failed to demonstrate that marginal changes in commission rates have any significant effect on the demand for securities. We would hazard that the effect of competitive rates on participation by individual investors will be minimal. There are far more basic causes at work than commission rates determining the degree of participation of the independent investor and the small issuer in the equity market. Tax policies are particularly important. Tinkering with an uneconomic commission rate structure

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is unlikely to do a great deal to lure the independent investor into the market.

Another version of the disappearing-small-investor argument focuses on reduced services. A reduction of total commission revenue will lead to a reduction in the amount of research done and a reduction of personnel in the industry. This means, the argument goes on, that the small individual investor will receive less research and less personal attention from his broker. In fact all predictions for decreased commission revenue are in the area of institutional business. Thus it is institutional research that will come under the most severe pressure and will be cut back. Supporters of fixed rates try to salvage the argument by claiming that retail research is a free spin-off from institutional research and therefore the two rise and fall together. However the institutional firms predicted to suffer the most will be those with the least retail business. Also research of elementary retail level could be acquired elsewhere. If it is as valuable as sometimes contended (which has been seriously doubted)[27] the individual investor will receive it. The cost is unlikely to be great because individual retail investors <u>collectively</u> are a group worth catering to and

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[27] "There is substantial evidence that a portfolio of the typical mutual fund or the typical bank trust department does not perform better than a randomly selected portfolio of comparable risk. Since these institutional investors probably have greater and more timely access to and better understanding of brokerage research reports and do not on average display superior performance, there is great doubt about the value of these reports to the average small investor", Friend and Blume, <u>supra</u> note 21.

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and if the demand is there a firm will soon start to supply advice which attracts business. In a free market system desired services will be provided. In the United States, industry representatives testified before the Senate Subcommittee on Securities that their firms would always make research available to the individual investor without separate charge. The relatively small amount which brokerage firms spend on research for individual investors makes it extremely doubtful that firms will attempt to achieve a competitive advantage by eliminating research.[28]

Besides, fixed rates do nothing to guarantee that adequate research will be provided. Brokerage firms are not obligated to do business at the request of the public and may decline to handle the accounts of small customers. Consequently, revenues derived from institutional business do not provide any rational, controllable subsidies to small investors. It is possible that competitive rates might well improve service to independent investors. If commission rates for institutions come down while those for individuals stay the same (as seems likely) the relative value of retail business will increase. Brokers acting in their own best interest can be expected to spend more time with, and provide better research for, their now-more-valuable retail clients. Thus the individual investor may be better served by competitive rates. If his patronage is not priced competitively (as the arguments for fixed rates imply) he will receive poor service. Users of passenger rail service experience the same phenomenon - underpriced service is generally poor service.

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[28] Securities Industry Study Report, _supra_ note 8, at 60.

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Power of the institutions

Fears have been expressed that the role of the financial institutions in the Canadian capital market is becoming too great. We would point out that institutions account for about 50% of agency business by value of trading on the T.S.E., compared with nearly 70% on the N.Y.S.E. according to the T.S.E. RAMA report of April 1976.[29] This suggests that they are a significantly less powerful force on the T.S.E. than on the N.Y.S.E. where no effect detrimental to individual investors has been observed since rates were unfixed. The same study also found that although there was a substantial increase in the percent of trading done by institutions between 1965 and 1970, that trend has not continued in the following five years. Institutions and intermediaries in 1970 accounted for 54.1% of agency business done by members of the T.S.E. In 1975 the figure was 52.7%.[30] This suggests that alarm over continued rapid expansion of the institutional share of the market is exaggerated.

Arguments in favour of fixed rates sometimes imply that financial institutions will be able to use their market power to the disadvantage of individual investors. We have already noted that a reduction of commissions charged to institutions involves no inequity if these commissions were artificially high

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[29] The Toronto Stock Exchange, Notice to Members No. 1344, "T.S.E. Study Indicates continued presence of individual investors in the equity market", 3 (April 14, 1976).

[30] Ibid.

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in the first place. We would add that it is unlikely that institutions will be able to use their greater market power to force independent investors to subsidize the commissions which the institutions pay. If commission charges are set higher for individual investors than is warranted by the cost of serving them, competing firms will attract retail business by cutting prices. Thus any attempt to over-price services to individual investors to subsidize the institutions is doomed to fail. Although one individual investor may lack bargaining power, individual investors as a group are an attractive market segment that brokers will strive to serve. The expereince on the N.Y.S.E. in the eight months since May 1975 confirms the view that fears of increased commission charges to individual investors are unfounded.[31]

Costs of exchange membership, fragmentation

It has been suggested that the costs of membership of the T.S.E., and particularly the costs of self-regulation and compliance with regulations imposed by other bodies, are so high that, in the absence of fixed rates, firms will leave the exchange in such large numbers that the market for securities will be seriously harmed. This argument, in effect, recognises that

[31] The S.E.C. reported to Congress in March 1976 that, for individuals:

> Commissions as a percent of the principal amount in December was below the rate in April for each of the order size groups except for orders between 200-999 shares where the rate showed no change.
>
> The commission cents per share in December, on the other hand, showed a significant drop from April in all of the order size groups, partially because of average price changes.

supra note 22 at 17, 18.

fixed rates generate monopoly profits, but seeks to justify those profits as necessary to finance the public interest in the regulation of securities trading.[32] The extent of the decline in the use of T.S.E. facilities will depend on the relative costs and benefits of using the exchange and using alternative markets. The natural advantage of trading on the exchange is that a centralized market attracts buyers and sellers. It is generally more efficient to go to a centralized market where other buyers and sellers may be found that to conduct an off-exchange search for the best deal. It is improbable that the costs of regulation are so great as to override these natural cost advantages. Even if some firms leave the exchange much of their volume can be expected to remain with other members because of the sheer efficiency of the system. Any suggestion that the benefits of exchange membership under fixed rates merely offset the costs of regulation is rebutted by the monopoly price which must be paid for a seat on the exchange.

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[32] The N.Y.S.E. tried the same argument eight years ago but without success. See New York Stock Exchange, "Economic Effects of Negotiated Commission Rates on the Brokerage Industry, the Market for Corporate Securities, and the Investing Public" 7, 22-23, 26-30 (August 1968).

The argument has been refuted by: William F. Baxter, "NYSE Fixed Commission Rates: A Private Cartel Goes Public", 22 Stanford Law Review 675, 703 (April 1970); by Professors Friend and Blume, *supra* note 21; and by 85 Harvard Law Review 794; "Note: Fixed Brokerage Commission: an antitrust analysis after the introduction of competitive rates on trades exceeding $500,000." (February 1972); and in the U.S. Securities Industry Study Report, *supra* note 21; at 58. See also the testimony of Mr. Haack, Chairman of the N.Y.S.E., quoted at 50.

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Transitional shock, bankrupticies, timing

Another argument that has been advanced is that bankruptcies of securities firms, caused by unfixing of commission rates, will shake the confidence of investors and thus seriously harm the capital market. This argument is relevant only to the question of how the transition to freely negotiated rates can be accomplished in the least disruptive manner. It hardly justifies the perpetual protection of uneconomic firms.

There are different ways of phasing in competitive commission rates. One is to progressively lower the "breakpoint", the value of a trade above which commissions may be freely negotiated. Another is to lower the minimum charge proportionately across the full range, for example by lowering the existing schedule by 5%. Once the basic decision (to apply the same competitive principles to orders below $500,000 as to those above) has been taken, the O.S.C. and T.S.E. can organise the transition in light of the financial strength of the marginal firms and the capacities of the National Contingency Fund.

APPENDIX: The United States Experience

Reasons for rule 19b-3

On January 23, 1975 the Securities and Exchange Commission adopted rule 19b-3 prohibiting the setting of fixed rates of commissions for transactions on any national securities exchange. The rule became effective May 1, 1975 (except for floor brokers). In its release adopting the rule, the S.E.C. gave its reasons for doing so:

> The basic reason for the Commission's decision to adopt Rule 19b-3 was the conclusion that, under present circumstances, 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 reasonably be devised. Furthermore, the Commission concludes that there is no economic requirement for fixed rates of commission in the securities industry, as is evident from the practical experience of the over-the-counter market, where no such structure exists, as well as all of the data which has been accumulated concerning the nature and characteristics of the securities commission business.

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> Consequently, even if it were possible to devise a better scheme of fixed rates, the commitment of resources would not appear to be justified under present and foreseeable conditions in view of the strong probability that no such system would work as well as competition.[33]

The S.E.C. went on to make clear that it was not proceeding on the simplistic notion that competition is desirable in all industries (particularly regulated industries) under all circumstances, but that it was satisfied that competition would benefit the securities industry. This brief has already stated the view that although the advantages of competition are not universally applicable (for example, in a natural monopoly situation), there is a general presumption in its favour which its opponents must rebut. Clearly their rebuttal did not persuade the authorities in the United States.

Effects of unfixing rates in the United States

The consequences of the elimination of fixed commission rates in the United states have been closely monitored by the S.E.C. and periodically reported to Congress. Three important facts emerge.

1) Commissions paid by individual investors have not increased significantly, if at all. (See Exhibit 1). We have

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[33] Securities Exchange Act of 1934, release no. 11203/January 23, 1975, in SEC Docket vol. 6, no. 4, Feb. 4, 1975 at 152.

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already commented on the fact that aggregate and percent of value calculations are misleading.[34] When analysed carefully, commissions paid by individuals do not compare unfavourably with those paid by institutions since unfixing of rates.

2) The nature and quality of the securities market have not been harmed by competitive rates. The S.E.C. reported in March, 1976 that investors appear to have benefited from reduced transactions costs, that there is no measurable change in the volume of trading or trading patterns, that the financial condition of broker-dealers as a whole remains sound, and that the quality of the market has not been adversely affected.[35]

> The Commission's measures of liquidity and price volatility indicate that competitive determination of commission charges has not affected adversely the quality of the market. Liquidity has increased during most months since May and stood recently at its highest level since 1972. Similarly, stock price volatility has fluctuated in a manner unrelated to the introduction of competition in rates.[36]

See above at pages 20-23.

S.E.C., Second Report to Congress, Supra note 22 at 2, 5 of covering letter.

Id., at 5 of covering letter.

The research department of the N.Y.S.E. has conducted its own studies of liquidity, spreads, and continuity. The findings of these studies are similar - competitive commissions have had little impact.[37]

3) The S.E.C. has concluded that experience with competitive rates has justified the adoption of rule 19b-3 and that there is no reason for even considering a return to fixed rates:

> These reductions in institutional commission rates have prompted some observations that institutional investors have been obtaining undue advantages and a few suggestions that there is a need to return to some system of fixed rates. In light of prior experience with minimum commission rate schedules, changes in rate levels and structures were to be expected and, while the evaluation in the rate structure will continue to need close observation, <u>there do not appear to be grounds for contemplating any return to fixed commissions</u>. (emphasis added)[38]

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[37] The New York Stock Exchange, Research report on Impact of competitive rates: a monitoring program report (December 9, 1975).

[38] Securities and Exchange Commission Report to Congress on The Effect of the Absence of Fixed Rates of Commissions, page 3 of covering letter (December 1, 1975).

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