BROKERAGE COMPETITION AND CAPITAL MARKET EFFICIENCY

by

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The TPC, according to its draft determination, "accepts that there is public benefit in the regulatory rules of the stock exchanges to the extent that they contribute to the more efficient operation of the stock market." An efficient securities market protects non-professional (e.g., small) investors in that, while they can never effectively compete (almost by definition) with the professionals, an efficient market ensures that all transact at "fair" prices for securities.

The TPC rejected the argument that fixed rates would protect the interests of small investors, saying that "competition" would be their best protector.

It is important to note that the TPC was referring here to price competition in *the market for brokerage services*. The relationship between such competition and the degree of efficiency in *the market for securities* does not appear to have been spelt out. This is unfortunate because the distinction between the two markets can become blurred, with the result that opposition to "competition" *per se* is attributed to anyone who might question the TPC determination.

In a price-competitive market *for brokerage services* research expenditures by brokers will be undertaken only if such expenditures are justified by the quality of the resulting research output; i.e., if the research leads to above average (risk-adjusted) returns. When research is justified and incurred it provides the basis for trading by brokers on their own account — which results in increased competition *for securities* (i.e., such trading contributes to the efficiency of the market for securities).

With fixed rates, competition in the market for brokerage services is not eliminated but is constrained to take non-price forms.

In the existing non-price competitive market for brokerage services (i.e., where price competition is suppressed by the fixing of commission rates) research expenditures are undertaken as a form of non-price competition. Research becomes justified only partly, if at all, by generating superior (risk-adjusted) returns — it is justified largely through the commission revenue it indirectly generates via its effects on attracting and holding clients, much in the fashion of advertising. Trading by brokers on their own accounts under the present arrangements does not have to cover the full or even part of the costs of research, since such costs have been sunk or incurred and covered by the brokers' commission services. Thus some unprofitable personal trading by brokers in a world of competitive brokerage rates (i.e. when gross gains are insufficient to cover research costs) becomes profitable under a fixed commission arrangement.

The end result is that more trading by brokers on their own account should occur with fixed brokerage that with competitive brokerage (unfortunately for the brokers, in their submission to the TPC they argued the reverse). The *increased competition for securities under fixed brokerage* means a potentially more efficient market for securities. The increased efficiency would result not so much from vastly superior research but from attempts to exploit any useful information in research undertaken as a form of advertising. Using the same quality of research as advertising to attract clients in a competitive brokerage setting is defeated by the dominance of price competition in the deregulated scheme. The total volume of trading, aside from that by brokers on personal account, may vary little under the two alternate brokerage-setting regimes.

In summary:

Competition for brokerage services can take price or non-price forms. It has been suggested above that non-price competition for brokerage services leads to greater competition for securities and hence greater efficiency in the market for securities.

The judgment of the TPC would have to resolve whether or not such increased efficiency is worth the higher cost of trading for non-brokers.