The Amex Statement

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There are a number of places at which I disagree with Mr. Kolton and his colleagues at the American Stock Exchange but before launching into criticisms, I want to thank him for providing the clear and forthright statement of his views. My task would have been more difficult if he had been less candid and less clear.

The central issue, as I see it, is the type of market place we are going to have. Economists and businessmen agree that the market system yields important benefits that are worth preserving, but often agreement ends there. The benefits that appeal most to businessmen are the profits that can be made; often they are willing to defend monopoly as a means of increasing profits. To economists, profits are only a means to an end. The goal or end is an allocation of real resources that corresponds to consumers desires as expressed by actual or desired spending. The features of the market system that appeal most to economists are the increase in efficiency, the elimination or reduction of monopoly profits, the increased benefits received by consumers, and the increased opportunities for choice.

The Amex statement, the Martin Report, and numerous other pieces written about the proposed reorganization of the securities markets either defend monopoly or urge the development of some new cartel. The purpose of the proposed arrangements is to prevent buyers and sellers from competing on price, service and other relevant dimensions of an exchange arrangement. The justification of the proposed arrangements is the standard justification of monopolies or cartels: to prevent some firms from being forced out of
business; to protect the small buyer; to protect the small seller, in this case, the seller of new issues; to prevent concentration.

Some unstated presumptions lie behind these arguments. One is that there are now too many firms in the securities industry. Inefficient firms are kept in the industry by the absence of competition. Another is that the small buyer pays too little for the service he receives, and the large buyer pays too much. If these presumptions are correct, investors in mutual funds, residual owners of pension plans, etc. are being forced to subsidize the activities of day traders, small investors and other buyers of odd lots and small round lots. A third is that part of the profit earned under the present system of fixed commission rates is used to subsidize the underwriting of new issues representing the ownership of small firms.

A conclusion that I believe is more likely to be true is that investors, including small investors are forced to pay for bad research, conjectures, gossip and unfounded opinion that is of little value to them. They also receive custodial services, accounting services, and the like, if they wish, at no additional cost, and the brokerage firm gets the opportunity to lend the securities held in street name without paying any additional fee to the customer. I am not sure who gains or loses most, and I doubt that we will find out until we introduce a competitive fee-for-service system or "unbundling" as it is often called.

The Amex statement and my comments open too many issues to discuss fully, so I will confine my remaining comments to a few topics. First, I don't see how the national market envisaged by Mr. Kolton and others improves the functioning of the capital market in its role as supplier of new capital to firms. In all the words written on the subject of
reorganization of the securities markets, very little is said about new issues, and much of what I read appears to be written as an afterthought. Who is going to make the markets for new issues and where will the trades be made? Are firms permitted to charge for the services of acting as dealer instead of broker? If so, why not allow the same privilege or opportunity on outstanding issues? Why can we not depend on competition to reduce the costs of service to a minimum?

Second, much of the discussion is directed to the problem of how institutional investor X should arrange to sell a large block to institutional investor Y. I do not want to minimize this important function of the market, but there is little chance of doing so. I wish to point out that this is the area in which competition is not only expected to function by providing cost saving alternatives, competition has already done so despite the counter-pressure provided by the organized exchanges in New York.

Mr. Kolton's argument runs counter to what we know about the functioning of markets. Changes have been forced by competition. The so-called third market developed. Institutional investors have attempted to purchase seats on some major exchanges. Both of these changes are the results of attempts to reduce costs of transacting. If the organized exchanges offered owners or holders of securities the opportunity to make trades at minimum cost -- if the monopoly power of exchange members was eroded -- there would be no reason for the third market to develop or for institutions to trade directly instead of through third parties. The middlemen -- exchange members in this case -- charged too much for their services.
Who gains from these changes? Institutional investors are intermediaries performing services for the public. With competition between intermediaries, lower costs for intermediaries mean lower fees for intermediary services. If this occurs, the public gains. They are able to acquire diversified, professionally managed portfolios at lower cost.

My final point concerns the amount of information made available on the trades that take place on various markets. Much of this discussion treats information as a free good that should be made available to all traders once a trade is completed. Until someone calculates the costs and benefits and shows who bears the costs and who gets the benefits, this proposition is not as obvious as it is taken to be. Even if I disregard these costs, as others do, I reach a rather different conclusion.

If information is to be made available at close to zero cost, the most useful information is the bid and offer position on the specialists' books. The amount of securities demanded at prices below the current market and the amount offered at prices above the current market price provides information on the variability of prices, the costs of reselling, and other aspects of the quality of the market. If the exchange system provides information of this kind, many of the problems that Mr. Kolton used to justify a single, national exchange would be resolved.