A blueprint for securities markets of the future

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It's time to take a good hard look at ourselves. What's happened during recent years, where we stand now, and where we'll be at the end of a year or two, depending on how intelligently we act.

And when we look at ourselves, let's be objective for a change. Let's take off the blinders and try to see ourselves as others see us. Those of you who have tried this exercise on your own will be familiar with the picture I am about to describe.

We see an industry that historically has given the appearance of being self-serving, and one which has appeared to have been kept in check only by government intervention. We see an industry that seems to have been so occupied with increasing its volume of business that it has not in the past equipped itself with the means to process that additional business.

We see an industry so torn by internal dissension and self-interest that it has become fractionalized—fractionalized to the detriment of itself, the investing public, our national economy, and the international role of our securities markets.

We see each segment of our fractionalized industry righteously claiming that its particular way of conducting business is justified because it serves a special need. At the same time, we see that these special needs do not necessarily coincide with the overall needs of the investing public, or the industry as a whole.

And we see that all of this has happened despite the paradoxical fact that within the securities industry there are as many men of intelligence, ability and foresight as in any other leading industry in this country. But their voices so far have gone unheeded.

Viewed from any perspective, this is a sorry picture.

What's more to be regretted is that there are still those among us who cannot see all this because they have not yet taken off their blinders. I'm beginning to doubt some ever will. I think it's time for us to recognize them for what they are—narrow-minded, selfish, individuals who do more than tarnish the image of the securities industry; they threaten the continued operation of the securities industry as a private enterprise.

Fragmented Market

The major problem facing the industry today is one of fragmentation. It is the root of all current ills. It has led to divisiveness, to internecine warfare, to throat-cutting competition, to bending of the rules established to insure equal opportunity to all types of investors, and last but certainly not least, a lessening of confidence by the public in the integrity of the securities marketplaces.

The situation can be compared to that which would occur if the various professional football teams around the country each determined on its own when and where it would play, whom it would admit to the games and under what conditions, and under what rules it would play each season.

I leave it to you to determine the degree of public support they would enjoy.

With that example in mind, let's take a closer look at the fragmentation that exists within our industry today.

We have the New York and American Stock Exchanges, the regional stock exchanges, the over-the-counter market, and the third and fourth markets.

No two operate under exactly the same set of rules, membership requirements are different or non-existent, transactions are reported promptly, tardily or not at all and some serve the small investor while the operations of others either make it difficult for him to participate, or exclude him entirely.

Even more important, the fragmentation of the industry has prevented it from speaking with one voice. Many of the problems which now beset the industry could have been avoided if the industry had collectively studied the implications of various issues and had taken positive action at the outset to oppose or support them.

I give you, as an outstanding example, the issue of institutional membership. When it first appeared on the scene, the various elements of the industry did not get together to study its long-range implications. It is true that the SEC did not give the subject the attention it deserved either, but this does not excuse us. The issue of institutional membership was permitted to grow from a concept—at which stage it could have been dealt with relatively painlessly—to a multi-faceted practical problem that to date has consumed enormous expenditures of time and effort in the attempt to find its solution, time and effort that could have been far better devoted to new and constructive endeavors for the industry and the public.

Joint Action Necessary

We must act jointly and promptly for our own good as well as the public interest. None of us, including the New York Stock Exchange, has given sufficient recognition to this fact in the past. We can't afford to delay such recognition for even one more day.

It is for this reason that the New York Stock Exchange has forwarded a letter of comment to the Securities and Exchange Commission concerning the proposal of the Midwest and PBW Exchanges to allow foreign brokers—non-members—to do business at a 40% discount from the fixed minimum commission schedule of those exchanges.

We have labelled this proposal premature and deserving of much study to determine its long-range implications before any decision is made. In the same letter of comment we also expressed our conviction that a uniform set of rules for membership and non-member access thereto should be established for all exchanges because such rules are essential to the formation of a central market system.

The past tendency to act individually and not collectively has extended at times into the promotional area, with potential harmful effect upon the industry as a whole.

It is one thing to advertise in order to remain profitable in a competitive environment. It is another to oversell, which can only bring trouble. And where the securities business is involved, overselling can bring trouble even more quickly.

Which brings me to the subject of NASDAQ.

Whatever its merits, NASDAQ is not an electronic stock market. There is no such animal and we all know it.

To put it bluntly, the NASD advertisements which state that NASDAQ is "The Electronic Stock Market" are to say the least misleading. The fact that an organization which monitors fair advertising practices could find itself in such a position concerns me greatly but not nearly so much as my concern for the serious damage the securities industry including the NASD may suffer as the result of inevitable public reaction when they discover the true capabilities of NASDAQ.

Let's describe NASDAQ to the public for what it is—a very important and significant advance by NASD (whose largest members, I might add, are also members of stock exchanges) in making available very limited market information on three thousand securities. I'm sure NASDAQ, which is at the moment only a display system, can be sold on the basis of its own merits. But it is not an electronic stock market—and, moreover, it does not fit any known definition of the term *market*.

To say that the securities industry should speak with one voice is not in any sense whatsoever saying that competition should not exist within the industry. Indeed, we must have more competition within the industry so that the public interest may be more fully served.

Two Central Markets

The most effective way to accomplish this is to gather together the various fragments of our existing industry into a "listed" market and an OTC market—one an auction market and the other a dealer market for practical reasons known to each of us.

The importance of establishing two central markets in the immediate future cannot be overstated. Indeed, we are rapidly approaching the 11th hour as far as staving off further consequences of fragmentation and consequent well-intentioned but not necessarily well-advised action by Congress.

I described the outlines of the securities markets of the future in a speech before the American Management Association almost two years ago while a Commissioner of the SEC. At that time, I said there would be exactly two markets. One would consist of an amalgamation of the existing exchange markets trading in listed securities. The other would limit itself to trading over-the-counter securities and would be operated by the NASD.

Access to either or both market systems would be available to all qualified broker-dealers. This involves the problem of providing compensation to seat holders who invested in their seats with the reasonable expectation that such access would remain strictly limited. This problem requires study in order to insure an equitable solution. In view of its importance, I am having the staff of the NYSE make such a study. I am confident that imaginative solutions will be found.

Equal Regulation

When the term "central market system" is used at this time, it is important to remember that first it is a concept and that what is meant is a system of communications by which trading on exchanges and in the over-the-counter markets will be tied together in separate systems. It follows that the system of communications is at the heart of each of the central markets. This fact warrants our further attention.

If the communications system is the heart of each of the central markets, the health of the markets, and indeed their ability to survive, will depend on the safeguards we build into the communications. Building such safeguards presents no problems if we keep in mind our objectives.

The paramount objective of any central market is to protect investors by requiring full disclosure of all trades executed anywhere in the nation. This means that all who have direct access to this comprehensive and valuable information must be governed by exactly the same rules. To permit even one exception will create an immediate competitive advantage. Fragmentation will be back with us, the central market concept will erode and disappear, and the securities markets will be operated as an instrumentality of the United States Government.

We can safeguard against this eventuality by taking the following steps:

First, requiring that within each market system market information from all sources be processed centrally.

Second, imposing upon all users of each of the market systems identical trading rules. One set would apply uniformly to trading of listed securities in the exchange market system, another would apply uniformly to trading in the over-the-counter market system.

These actions would insure the viability of the two market systems. There would be no opportunities, as now exist, for entrepreneurs who want in on the action, but only on their own terms.

The Third Market

Today, for example, we could well spotlight the third market, which may not be able to withstand the searching light of scrutiny. How is the public interest served when sales prices and volume are not immediately disclosed? Obviously there are advantages—I don't know any third marketeers who work for charity alone—but who are the beneficiaries? Not by any stretch of the imagination can they be labelled the securities industry itself or the investing public as a whole. Some would say that the "third market" provides needed competition. Such sophistry, articulated in the guise of competition, endangers the public interest because of the absence of a regulatory scheme surveilling this self-created market.

Fortunately today even the third market firms have come to realize that it is the competition of all orders within a central auction market system which will enable public investors to obtain the best possible price. The history of exchanges, especially the New York Stock Exchange, demonstrates that only by concentrating the flow of orders within one market or one market system can the best price, that is the narrowest bid-offer spread, be obtained.

There is another aspect to third market operations which deserves attention. This is that securities can be traded in complete disregard of the wishes of the issuers. As far as I am concerned, it is the right of the issuer to determine where his securities are to be traded. I advocated this belief before I came to the Exchange and I will continue to advocate it in the future. And I am glad that finally that concept is now being supported by the SIA.

Need for Legislation

For the reasons I have outlined, I intend to ask the Board of Directors of the New York Stock Exchange to recommend legislation which would require trading in all listed securities to take place on exchange markets, in accordance with the wishes of the issuers of those securities. Further, I am going to recommend that such legislation become effective at the earliest possible date. There doesn't seem to be a valid reason in the world why such action should be delayed until a central market system is developed and implemented. On the contrary, integration of the third market into existing exchanges would remove a potential threat to the achievement of a truly central market goal. The third market firms can protect their immediate economic interest by joining the primary exchanges. Ultimately they along with any other qualified broker-dealers would become members of the newly created market system.

Turning briefly to the subject of the fourth market, I have two observations to make. The first is that to date a relatively insignificant amount of trading is involved. The second is that any trading in listed securities which is not disclosed to the public is *ipso facto* not in the public interest. Rules for public disclosure in this market are essential to the full development of the central market system.

What I am recommending for the OTC, third and fourth markets is not self-serving, but in the public interest. Let's apply the same test of public interest to the exchange marketplaces. Here we see that almost instant disclosure is made of the price and volume of each trade. We also see that the exchanges function as auction markets, where the action is open and competitive. Open and competitive bidding —open to the point where any person in the country can stand in the galleries and watch—is the ultimate when it comes to protecting the interests of the investing public.

It was precisely because of the need to foster competition within a regulated environment that the New York Stock Exchange offered to make its specialists' quotes available to any regional exchange which would reciprocate. If that proposal becomes a reality, we can look forward to healthy, open competition between the trading floor of the New York Stock Exchange and those of the regional exchanges.

At the same time we are working diligently to bring into being a composite transaction tape which would display price, volume and where the trade took place. As you probably know, a series of meetings have been held to determine how this can be done. I am glad to be able to report that the working committee is still moving forward and hopes to submit a joint plan to the SEC later this month on how this tape should be implemented.

Role of Self-Regulation

I said at the beginning of my remarks that it was time to take a good hard look at ourselves. I believe I've made my views known this morning. But I have something more to say.

Nothing that has happened in the past forecloses in any way our ability to demonstrate that self-regulation, or if you prefer cooperative regulation, works. I point to the errors that were made, not in an accusatory vein, but with the hope that we will benefit by not repeating

these mistakes in the future.

During the coming year we will see additional regulation proposed by concerned committees of Congress. That which on the surface may appear to be in the public interest—but in fact is not—I will oppose. That which is definitely in the public interest, I will support.

Finally, a few words to the investing public.

A Vital Marketplace

I have spoken today with no regard to the vested interest of any segment of the securities industry. I have done this openly, because I believe it is your right to know what efforts the industry is making to exercise its responsibility to you. I have necessarily dealt with current and future problem areas, and I have given my views as to how these might be resolved on the basis of the public interest.

I would ask that you view these in the perspective of the long-term contribution the securities industry has made to the economic welfare of our country, and of the contribution it will make in the future.

The inter-relationship between the securities industry and those agencies of the federal government concerned with its operation is both a necessary and healthy one. We each have something to offer. For the industry it is the expertise gained from years of experience in a highly complex area. For the members of government, it is the authority to enact rules and laws, which in many cases we ourselves have requested, to insure that all investors are afforded equal opportunity and protection.

Neither can operate in the securities field without the other, and that is why our relationship is both necessary and healthy. And because of this relationship you may be confident that the securities marketplace will remain strong and viable. And this in turn will help to build an even more prosperous America, with greater opportunities for you and your children, higher standards of living, and the means to contribute even more to the development of those nations and peoples less fortunate than ourselves.

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