THE IMPLEMENTATION OF THE
CENTRAL MARKET SYSTEM

An Address By

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The Central Market System appears to be an idea whose time has almost come. It seems to have started with the Commission's letter transmitting the Institutional Study Report to the Congress on March 10, 1971. That letter said:

"In summary, our objective is to see a strong central market system created to which all investors have access, in which all qualified broker-dealers and existing market institutions may participate in accordance with their respective capabilities, and in which is controlled not only by appropriate regulation but also by the forces of competition."

Later that year, Mr. William McChesney Martin put forward the idea in somewhat different form in his report to the New York Stock Exchange, and the Commission has further developed the concept in its Policy Statements of February 2, 1972, and March 29, 1973. Several principal features of the system have now emerged. It will eventually be a system for trading in listed stocks, the over-the-counter market and the bond markets are too diverse to be easily fitted into the system. All markets for listed stocks will be linked together by a system of communications built around a consolidated transaction reporting system, and a consolidated quotations system. This will open up the market-making function to competition. At present this essential function is fragmented, there is one specialist in each
of four or five exchanges, there are block positioners, up-stairs market-makers and third market-makers each operating in isolation and separated by various exclusionary rules. In the Central Market System all qualified market-makers will have the opportunity to participate and can be obligated to do so.

This emphasis on strengthening the dealer function has led some to fear that the central market will be a dealer market, and that the values of the auction market will be lost. This need not and should not happen.

In its 1973 statement the Commission proposed two rules. The first rule would require that public orders entered in an electronic repository would be entitled to price priority protection throughout the system, much as orders on a specialists book are now protected on each exchange. The second rule would accord preference to public orders by preventing any dealer from participating as principal in any system transaction unless his purchase price is higher or his sales price lower than any public bid or offer recorded in the system.

In view of the emphasis frequently placed on the desirability of an auction market it seems in order to consider how the auction market operates now on the principal exchanges. The auction market is often described in terms of public orders meeting in the "crowd" on the floor of an exchange. This really does not happen too often, except in very active stocks. About 6% of the volume on the New York Stock Exchange is executed in this way. It appears, however, that a very substantial part of this volume is accounted for at the opening. Of course, execution of public orders on the specialists book account for a much larger percentage.
This type of execution, which is the more important aspect of the auction market under present conditions, would be better served under the Central Market System since with a nation wide repository for public orders, such orders would have the opportunity to meet public orders anywhere in the system and would enjoy participation and priority over all dealer trades anywhere in the system, not merely the dealer trades of a particular specialist. Moreover, a primary justification for the auction market is that it affords a better execution than a dealer market since it eliminates the dealers spread. If, however, dealers perform satisfactorily and, under present conditions this may be rather large if, the advantages of the auction market in terms of better executions is limited to the gap between the dealers bid and the dealers offer. On balance it would appear that the values of the auction market would not only be preserved but enhanced in the Central Market System.

The idea of a Central Market System has achieved wide acceptance. It has been endorsed by the New York Stock Exchange, the Treasury Department, the Commission, and importantly by the Congressional Committees which have jurisdiction over securities regulation in both the Senate and the House. Indeed the main securities bill which has passed the Senate, S. 2519 is entitled "The National Securities Market Systems Act of 1974", and Title VI of the comprehensive House bill, H.R. 5050 which is now awaiting action on the floor of the House includes a proposed finding by the Congress that a national securities market system should be established. Moreover the creation of the Central Market System has started. The pilot phase of the
Consolidated Tape is now in operation and the Commission has proposed the adoption of Rule 17a-14 calling for a composite quotations system. Most significantly the Commission has appointed an able, broadly representative and hard working Advisory Committee on the Implementation of a Central Market System, and that Committee is holding its sixth meeting today. That Committee hopes to be able to distribute a statement on the "Basic Characteristics and Principles of the Central Market System" following today's meeting.

Yet all is not clear sailing ahead. While the basic concepts of the central market system, or the national market system as Congress proposes to christen it, are coming clear, it will not be easy to translate those concepts into concrete realities. I do not think, however, that this task is inherently overwhelming. The necessary rules can be written and the necessary hardware and software can be provided, indeed much of it is already in existence. Somewhat comparable achievements by the securities industry come to mind such as the network of communications linking the New York Stock Exchange with all parts of the nation and the world, or, on a smaller scale, the creation of NASDAQ. The problem is not how to do it, the problem is how do we agree on what to do and how do we get from here to there. For example, it has been suggested that it would be better if we postponed the consolidated quotes until the Central Market System has been designed, agreed upon and put into place. Certainly this seems more orderly and in an ideal world it might well be the best way. But if we shelve the consolidated quotes indefinitely, will we also shelve the Central Market System indefinitely and what use will the consolidated tape be if no one need pay any attention to it? It may be that the Central Market System cannot be agreed upon until it has to be.
These problems raise questions which transcend the mere mechanics of a new system for the transmission and execution of orders, the Central Market System becomes involved with other issues. These include the question of fixed or competitive commissions, institutional membership and the related question of combining brokerage with money management, and the impact of financial institutions on the securities markets and the securities industry, including the role of the banks. It used to be said that fixed minimum commissions were the cement that held the exchange market together. That cement, however, has come unstuck largely by a reason of the pressures of financial institutions which have fragmented the markets in their quest for commissions not artificially determined and for better execution of their large orders.

In any event the fixed minimum commission seems to be on its way out. Not only is Congress inclined that way, but the Board of Directors of the New York Stock Exchange in their resolution of October 16, 1974, recognized that competitive rates must come, at least for public orders, but wants what I interpret as a version of the Central Market System first. I will not here discuss the question of whether the fixed minimum commission should end on May 1, 1975, since that is a question which we will be called upon to decide after hearings to commence on November 19, 1974. But there is one point which I think has been largely overlooked in the debate over fixed versus competitive commissions. It sometimes seems to be assumed that the choice is between the dangers and uncertainties of competitive
commissions and the comfortable world of fixed commissions as it existed before, say, 1960. In those days the New York Stock Exchange fixed commissions pretty much as it pleased with no very discernable principle except perhaps the idea that when volume went down commission rates should go up. Since then there has been a search for a more rational basis for fixing commissions for this diverse and volatile industry, but it has not yet been found and the Exchange has been pretty well reduced to periodically seeking emergency relief. We must realize that in this society of free and competitive enterprise the privilege of fixing prices has been reserved for public utilities, and the securities industry cannot hope to be the sole exception forever. We should think a little about what being a public utility means.

First of all it means extensive and pervasive government regulation. A public utility must get permission to go into business. It must sell only what it is authorized to sell, and only where it is authorized to sell it. Its expenses must appear prudent to its regulators and its income must be predictable, so that its revenues just cover its necessary expenses plus a reasonable return on capital. While in the present time of trouble some of you might find the security of such confinement comforting, I do not believe, nor do I think you believe, that it would provide either a viable or desirable future for the securities industry.

I rather suspect that by this time you may feel that too much is happening all at once in the securities industry and to the securities industry, and that it is happening at the wrong time, when the securities industry is suffering from its own private depression. If you do feel that way I do not
blame you, indeed I rather share that feeling. It would be pleasant if we could proceed at a leisurely pace doing one thing at a time, and then only when the time seemed to be right. But I doubt if that leisure will be granted us, for a number of reasons. In the first place the Congress seems to be on the point of adopting far-reaching securities legislation. I do not know whether it will come this year, although I think so. If it does not, it will probably come fairly early next year. The Senate bills were passed some time ago. On the House side, the Subcommittee on Commerce and Finance developed a comprehensive bill, H.R. 5050 mentioned above which was favorably reported on by the full Committee on Interstate and Foreign Commerce on October 10, by a vote of 36 to 1. It is expected that this bill will be considered on the floor of the House fairly promptly after Congress re-convenes. If it passes, which seems likely, it will be necessary to reconcile the difference between the House and Senate bills in a Conference Committee.

This legislation is complex and its final form cannot be known until after the Conference Committee acts. The following are the principle features contained in both the House and Senate bills and, likely therefore to be included in one form or another in the final legislation. Progress towards the Central Market System will be mandated, including provision for the development of an improved national system for securities processing including the immobilization of stock certificates, and increased reliance upon competition, particularly among dealers. The Commission's authority over the Exchanges and the NASD will be strengthened and clarified including authority to require changes in Exchanges and NASD rules. Institutional membership will probably be prohibited. The House bill provides for the
elimination of fixed rates on May 1, 1975, but would authorize the
Commission to extend that period if necessary, while the Senate bill
does not set a deadline but does clarify the Commission's authority to
do so.

The Congressional Committees have been studying these matters
for about four years and they clearly will now expect action.

Even aside from Congressional mandates, the present condition
of the securities industry is profoundly disturbing. Neither we nor
you can do much to change the basic causes of declining markets and low
volume. These spring from fundamental economic problems such as inflation,
high interest rates, and general uncertainty concerning future developments
in the economy. But the existing uncertainty concerning the future
structure and functioning of the securities markets is certainly not
helpful and we can at least do something about that. There seems to be a
desire in some quarters to postpone the painful dislocations, trials and
tribulations of change in the expectation that the market will turn around,
which we all believe it will, and that when it does, change will somehow
become either unnecessary or painless. I do not think we can afford to gamble
on this. If the securities industry does not adjust to the future, there is
no necessary assurance that the independent securities industry as we now know
it will be there when the future arrives.

My friend, Charles Ellis of Greenwich Research Associates, who
is quite often guilty of original thinking about the securities markets
has written a paper which makes some interesting points. I do not endorse
his ultimate conclusion which seems to be that the institutions and the
banks are likely to take over a large part of the brokerage function, but his insights are instructive. He makes the point that we are now in the midst, for the second time in this century, of a fundamental change in the structure of the securities markets. The compelling reason for both changes is the same, the emergence of a new kind of predominant user of the markets whose important needs were not well met by the existing structure. The first change occurred in the 1920's and the 1930's. Before World War I the predominant users of the equity markets were a relatively small group of comparatively wealthy and sophisticated investors and traders, most of whom were the owners or managers of businesses. In 1920 these were largely supplanted by tens of thousands of smaller individual amateur investors located throughout the country and not just in a few financial centers. During the succeeding decades an extremely effective mechanism was developed to meet the needs of these small investors wherever they might be, at comparatively low cost for each individual trade. I might add, although Mr. Ellis does not explicitly make this point, that this change was not wholly accomplished by the voluntary initiatives of the industry. It took federal legislation to provide changes in market operations necessary for the protection of these investors and initially this legislation was not exactly welcomed in some quarters and there were those who suggested that it would result in "grass growing in Wall Street". Further this part of the change came only after adverse market conditions had exposed the need for it.
Similarly, Mr. Ellis suggests that current fundamental changes are attributable to the emergence of a new type of predominant user, the financial institutions such as pension funds, mutual funds, investment counselors and bank trust departments who, according to his reckoning, act on behalf of between 40 and 50 million individual investors. The present system, he concludes, is not well suited to their needs. In the first place execution of their large and frequent orders costs too much, particularly as they have no need for a large and expensive network of branch offices and salesmen. They also need a stronger execution system than can be provided by a single modestly capitalized specialist enjoying a monopoly franchise, and alternative channels to meet their needs that are evolving. Moreover, the institutions have their own trading capability and could execute their own orders, as intermediaries for the individuals they serve. It is about here that I part company with Mr. Ellis insofar as he says so little about the individual investor who still prefers to invest separately not collectively and to make his own investment decisions. Mr. Ellis concludes that he should be protected without going into details, except to suggest that an individual who wants to make his own decisions could have them executed at low cost through a commercial bank.

Since Mr. Ellis is discussing the trading market he does not say a great deal about the capital raising function except to suggest that if individual investors increasingly choose to act through institutions as intermediaries then the institutions will become the intermediaries through whom capital is raised. In recent discussion great stress has been placed on the importance on the capital raising function of the securities industry and there can be no doubt that this function is vital. It is not so clear,
however, that the trading markets should be organized and operated in an inefficient manner in order to subsidize the capital raising function of the securities industry. Traditionally the raising of capital by the distribution of new issues has not only been one of the most essential functions of the securities industry but also one of its most rewarding. Unfortunately the current depressed condition of the securities markets has been accompanied by a dearth of new issues to distribute. When an attractive issue comes along there seems to be no lack of capacity to distribute it — floating rate notes and money market funds are recent examples. Clearly, however, one reason for seeking to bring the individual investor back into the equity markets is his importance as a source of capital for industry. I think, however, that the individual investor will return whenever he finds the opportunities for profit in the equity markets both for new issues and for outstanding securities to be attractively both absolutely and in comparison with other available investment opportunities. The equity markets simply are not attractive so long as the stock market persists in going down and so long as high interest rates make fixed income securities appealing. There is not much that the securities industry or the Commission can do to remedy the basic economic problems that have given rise to these conditions. There are some deterrents to equity investments which, however, are not the necessary product of basic economic problems and about which I hope we could do something. One of these is the extent to which the tax laws discourage equity investment in productive enterprise, including double taxation of dividend income and the structure of capital gains taxation. There is, I think, another tax deterrent to productive equity
investment with respect to which the securities industry and also the
Commission have not spoken out and that is the proliferation of so-called
tax shelters. Under this label various esoteric investments of dubious
economic merit including all kinds of schemes for speculation in real
estate, oil drilling, cattle feeding and what have you, are marketed on
the basis of tax deductions rather than on the basis of investment income
or growth. These offerings distract the attention of the securities
industry from its basic function of raising capital for productive
industry and they provide the Commission with a prolific source of fraud
cases. They also lure away from the equity markets that segment of the
population which should be your best customers, that is, wealthier
investors in the higher income tax bracket who are best able to take
the risks and reap the rewards of equity investment. If we are sincere
in our allegiance to the raising of capital for American industry, we might
well join in the effort to close some tax loopholes which cause a
leakage not only of revenue for the treasury but of capital for industry.

Returning to Mr. Ellis, even though we may hope that his
predictions do not come to pass, I think he has provided a very useful
insight as to how we got to where we are now. But the scenario he suggests
could happen unless something else happens. There will, I believe, be
room in the Central Market System for the broker and his clients as well
as the institution and its beneficiaries. But, I submit, we should get
on with implementing the Central Market System.