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THE NATIONAL MARKET SYSTEM IN PERSPECTIVE

An Address by  
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I am very pleased to have the opportunity to address the Securities Industry Association this morning. In fact, I have been looking forward to these remarks with considerable anticipation. That anticipation – and even curiosity – stems in part from recent press accounts that this forum will include an announcement of the results and conclusions of the Commission’s pending proceeding on off-board trading rules and an articulation of the steps necessary for creation of a national market system. Let me assure you that no one in this room is more anxiously awaiting that portion of the program than I am.

In any case, speculation concerning the content of my remarks is perhaps the most benign of the predictions, guesses, and purported inside views which have appeared concerning the Commission’s work towards the development of a national market system. I hope this morning to be able to dispel some of the misimpressions and misunderstandings which these accounts may have created and to help you to understand both the process and the considerations which the Commission will bring to bear in the course of its work to facilitate creation of the national market system mandated by Congress.

An Approach to Regulation

Before turning to some observations concerning the securities industry, I want to provide a bit of insight into my own philosophy and style so that you will have some sense of what to expect from the Chairman of the Securities and Exchange Commission during the next five years. When I accepted President Carter's invitation to lead the Commission I believed – and I still believe – that the issues which the Commission's Chairman will face between now and 1982 are important enough to our economic future to merit the five-year commitment he requested. Accordingly, we will be bound to one another for a considerable period of time, and it is crucial that, as partners in the business of ensuring the effectiveness and efficiency of the markets, we understand one another from the outset.

I have a real appreciation for the role of capital formation in stimulating and providing the life blood for the most successful economic system in the history of the world. I have committed myself over the years to situations and opportunities about which I have strong convictions and to which I think I can contribute something that will

make a difference. I decided to leave private business and accept the deanship at UCLA because I saw an opportunity to build an outstanding school and to introduce some important and innovative concepts in management education. Similarly, I came to the Commission primarily because of my concern for the integrity of the capital formation process and the private enterprise system generally. Public confidence has been shaken – confidence which must prevail if the private capital markets are to survive and finance our economic future. Questions have been raised, for example, about the integrity of corporate earnings, about whether American business is run in the best interests of its shareholders and the larger society of which it is a part, about whether our equity markets are an attractive and fair place for the individual investor to place his after-tax investment dollars, and about the inability of small businesses to gain vital access to capital markets. For these reasons, in my judgment, there has never been a more important time in the history of the Commission to be its Chairman.

## The Role of The Securities Markets

As each of us – securities professionals, corporate executives, investors, government regulators, and private citizens – struggles with the challenges facing the securities industry, it is key that we bear in mind the role which those markets play as an element in our overall social fabric. In our economy, the securities markets serve as the vehicle through which capital is channeled from private hands into what are, ultimately, national priorities – the creation of jobs, the provision of equipment and facilities necessary to produce the goods and services which define our standard of living, and the assurance of economic security for our citizens. In that sense, it is not an overstatement to say that the securities markets are at the heart of our society. If the public loses confidence in the fairness and integrity of our capital markets and of the businesses which these markets have fostered and which they sustain, then the result, inevitably, will be a restructuring – not just of our securities markets, not just of our private enterprise system, but of the principles on which our society is based.

Viewed from that perspective then, the challenges and responsibilities facing the securities industry today are national, not merely industry, concerns. With that premise in mind, I would like to turn to a brief overview of some of the problems which I see facing the industry.

### An Economic Profile of the Securities Industry

During the past 10 years, our capital markets have been subjected to unprecedented economic and regulatory stresses which caught us largely unprepared – a shock wave after two decades of unbelievable and virtually uninterrupted economic growth which peaked in 1968 with industry revenues of over five billion dollars. During the '60s, the economy was good and the market was great. The average annual compound rate of return for the Standard and Poor's 500 was just short of 15 percent. During that entire period, there were only four years in which the market declined. Until 1969, many professionals in the securities industry and many investors had experienced no other kind of market. Many assumed – or at least hoped – things would continue that way forever.

The 1970s, by contrast, have already seen two recessions, one the sharpest and most protracted of the postwar era. Inflation – a problem which 10 years ago many economists thought to be controllable – has proved remarkable in its ability to resist fiscal and monetary cure. Indeed, inflation is beginning to exhibit a tendency to become a permanent feature of our economic landscape. Inflation, in turn, breeds recession. It causes business to limit expansion, to delay expenditures, and to play it close to the vest.

Another economywide problem which has had a severe impact on the securities industry is the overall low rate of profitability of American business. I have spoken extensively on this subject on several recent occasions. For the present it should suffice to point out that, regardless of the ever-increasing figures which appear on the bottom line of corporate income statements, the earnings of business – in terms of real purchasing power net of the economic cost of consuming assets – are dangerously low and totally inadequate.

Inflation, unemployment, low profitability, the energy crisis and the related jump in oil prices, and an erosion of confidence in leadership – all of those factors and others have had an impact on the securities industry.

For these reasons, just as the rush into the market during the '60s was a natural response to the prevailing economic climate, it is hardly surprising that individual investors continue to leave the market today. U.S. Government No.8s of '83 yield 7.5 percent. AT&T bonds can be bought to yield more than 8 percent. Quality municipals are similarly attractive. Under these circumstances, is the incentive to invest in the equity market commensurate with the added risks?

Ever-increasing amounts of individual savings are finding their way into pension funds and other institutions. At the same time, however, these institutions themselves have been placing a larger share of their own new money in fixed income securities and equities which can be justified under ERISA.

Developments such as these have serious negative implications, particularly for new equity issues which have become virtually extinct as contrasted to the late '60s and the early '70s. Today, only the higher-quality, well-capitalized companies enjoy access to the equity markets. And even for them, the cost in terms of price/earnings ratio is high. The problem is even more serious for companies seeking to come to market for the first time. And many companies cannot raise additional debt without expanding their equity base. Thus, they are caught in a growth-constricting vise. Such firms must either restrain their growth or be acquired by larger companies. Either course stifles creativity and innovation. In sum, the shortage of equity capital, in the long run, inhibits technological advancement and dampens increases in productivity. It prevents the development of the Xeroxs and IBMs of tomorrow.

The impact on the securities industry itself of the economic and market conditions which prevailed during the earlier years of this decade has been tremendous. Perhaps the most serious consequences of this period have been the loss of public confidence in the markets and the illumination of structural weaknesses in both the securities industry and

in its regulatory organizations. Further, beginning with the back office problems of the late '60s and followed by shrinking volume, profit margins declined, firm capital was severely impaired, and a number of firms liquidated or merged.

Against this economic background, the industry confronted the regulatory challenges which began with the abolition of fixed commission rates on May 1, 1975, and which will extend through the creation of the Congressionally-mandated national market system. As May Day approached, some suggested that Wall Street's population would quickly be reduced to a few predominate firms, none of them members of the NYSE; a massive shake-out was foreseen as firms scrambled for market-share, and, because of their cost structures, were successively priced out of competition.

Although these analysts proved to be unduly alarmed, the very real costs that have been borne by members of the industry during this transition to price competition cannot lightly be dismissed. Since May 1, 1975, something on the order of 100 New York Stock Exchange member firms have disappeared. Further, firms which had depended on one type of service for the bulk of their revenues have been forced to explore the feasibility of providing, through one means or another, a wider range of financial products and

services. In fact, I think it clear that there is a connection between the demise of fixed commission rates and the explosion of interest in the trading of standardized options.

Further, I am concerned that some of the commission charges and competitiveness now going on may, in effect, be predatory and destructive. These are the sorts of economic and regulatory interrelationships that the Commission must explore in order to gain a better understanding of the dynamics of the marketplace.

Moreover, the recent trend of mergers in the industry must be seriously examined. To the extent that mergers result in stronger managements, greater operating efficiencies, sounder capital structures, and better service to customers, and ability to respond to and survive the changes in the industry, they can be healthy. To the extent that they may impair liquidity, result in undue concentration, stifle the ability of small, speciality firms to thrive – and to the extent that economic concentration is in anticipation of an imagined future market structure which has not yet been defined – I am troubled. Has the concentration gone too far? We need to look at that carefully. I do not think the verdict is in. I understand the legitimate and very real concerns which many of you have voiced.

I share that unease. If industry concentration impairs the liquidity, depth, and character of our markets, it will be of serious concern at the Commission.

In this same connection, I should note that there is much we do not yet know about the general impact of negotiated rates and their specific impact on the consolidation movement. Better information from the industry would assist us in understanding both the real impact of negotiated rates and the way in which the business is changing, and in dealing responsibly and timely with potential problems. In order to facilitate reaching that goal, I have asked the Commission's economists to seek some detailed financial information – on a one-time, voluntary basis – from selected firms. While there is, of course, no obligation to reply to this type of inquiry, I urge those contacted to cooperate. In the long run, it will surely benefit the industry for me and my colleagues to have the best possible understanding of its economics.

The most recent financial data presently available on the operating results of securities firms tell a somewhat mixed story. During the first three quarters of 1977, New York Stock Exchange member firms doing a public business had aggregate pre-tax

income of \$328 million – less than half of the \$753 million earned during the same period in 1976. This decline can, however, be better understood if we remember that 1975 and 1976 were exceptionally good years while 1973 and 1974 were unusually poor. Because of this volatility, it is not easy to define an average year for the securities industry. What can be said for the 1977 results to date is that they are neither especially good nor particularly bad, but somewhere in between.

In summary, the securities industry is enduring a period of unprecedented upheaval in its economic environment – without relief in sight. The combined results of a more restrained national economy and unfixed rates of commission have worked important changes in the industry – but have not crippled it; more than two years after the unfixing of commission rates, the industry remains viable and resourceful.

With this picture of the current health of the markets in mind, I would like to turn from the industry's past and present to its future – the development of the national market system.

### The Development of the National Market System

When I joined the Commission some seven months ago, I said that I felt as though I was boarding a train moving at full speed that would only stop for an instant, if at all, to pick me up. The Commission's journey toward a national market system has been a long one – one that commenced well before my arrival.

As many of you know, the concept of a national market system was first articulated by the Commission in March of 1971, in the Commission's letter transmitting the Institutional Investor Study Report to the Congress – more than four years before the enactment of the 1975 Amendments. In succeeding years, the concept was amplified in Commission hearings, by Commission policy statements, and in various Commission rulemaking proceedings covering a broad range of subject matters – including various proposals and requests for comment regarding the implementation of a composite quotation system, a consolidated transaction reporting system, a composite book, and the removal of fixed commission rates.

The 1975 Amendments established the necessity of developing a national market system as a matter of national policy, and provided the Commission with new specific grants of authority with which to pursue that goal. In short, the Congress directed the Commission, “having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under [the Act] to facilitate the establishment of a national market system for securities in accordance with” specific Congressional findings and objectives.

Obviously, the purpose of the Congressional mandate is to enhance the quality and integrity of the markets, not to diminish them. Congressional language is replete with this message, for example:

“[I]nvestors should be able to obtain the best, most economic and fair execution of their orders and be assured that, because of open competition among market makers, the total market for each security is as liquid and orderly as the characteristics of that security warrant.”

and Congress believed that:

“[E]very effort should be made to design the national market system in such a way that public investors [in securities which are suitable for auction trading] receive the benefits and protections associated with auction-type trading.”

and finally, the Act itself says:

“The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investor orders, and contribute to best execution of such orders.”

Pursuit of a national market system is among the most difficult and challenging of the many tasks that the Congress has assigned to the Commission. Before we reach journey’s end, we must do far more than formulate rules and procedures to preclude conduct clearly perceived as wrongful or inimical to the public interest, or to enforce relatively well-understood standards of behavior. In order to facilitate – and I use that word to connote some degree of restraint – movement to a national market system, it now

appears that the Commission must assume a leadership role in the design of the structure of the marketplace and the development of communications, processing, and other technological systems that may alter significantly the methods by which securities are traded. And, to assure that these systems function appropriately, it will be necessary, in conjunction with self-regulatory organizations, to design rules to channel the conduct of market professionals so as to maximize appropriate use of those facilities in the context of an evolving national market structure and system.

The Commission, in pursuing the development of a national market system, has moved somewhat cautiously. Changes that impact structure must be carefully considered, must create stronger and better markets for all participants, and must improve the integrity and fairness of the marketplace. Requiring development and use of new systems necessarily increase, if only in the short term, the costs incurred by the securities industry and, ultimately, by the public investors who use the markets. Those costs frequently seem so substantial – and, paradoxically, so difficult to quantify – that the Commission has to weigh carefully, in each instance and in advance, the feasibility and practicality of each system the Commission might consider requiring. Similarly, in

addressing national market system concerns which do not depend upon specific technological innovation – but nevertheless involve fundamental restructuring of the regulation of trading by the Commission and the self-regulatory organizations – the Commission perceives a special need to grasp clearly and as completely as possible the consequences of its actions. Moreover, and perhaps more importantly, the Commission must be prepared to implement appropriate collateral steps to assure that public investors and market professionals are not injured and any other adverse effects on the orderly functioning of the markets are avoided.

Last month the House Subcommittee on Oversight and Investigations, and the House Subcommittee on Consumer Protection and Finance, roundly criticized the Commission for not using its authority more vigorously to facilitate the establishment of a national market system. Those House Subcommittees also charged that the securities industry has failed to take the initiative in this area and urged that the Commission now exert the leadership necessary to develop more fully a national market system. Similarly, many of the witnesses in our recent off-board trading hearings, a good number of whom I see here today, recognized that progress toward the national market system has been

slower than expected and expressed the view that additional leadership from the Commission is necessary and desirable. Yet I do not believe that anyone involved in the enactment of the '75 Amendments expected that the problems associated with the movement toward a national market system would be solved easily or rapidly. There are simply too many pieces to this most complex and fascinating puzzle.

The Commission is not, however, satisfied with the current rate of progress, despite the difficulty of the task. In part, we believe that progress has been impeded by the apparent inability of several of the self-regulatory organizations, and several of the discrete segments of the securities industry, to overcome their self-interests and to settle upon a common course of action to implement the Congressional policy. The Commission recognizes that an industry with many, often diverse, interests may find it difficult to come together. Nonetheless, we are concerned with the inability of the industry to provide its own leadership – even when it claims to feel as threatened as it does. It is unfortunate that the industry would let those who control the existing mechanisms protect their own vested interests, at what may well be the expense of the

industry as a whole. As a person who has devoted a major portion of his life to encouraging and participating in private sector initiatives to prevent or obviate the need for government intervention, I am especially concerned with the broadly-based industry criticism of the Commission for not filling that void and providing that leadership. If, however, Congressional and Commission expectations that the industry will design and implement a national market system remain unfulfilled because of the diversity of economic self-interests, let me assure you that this Commission will discharge vigorously its full responsibility and authority under the Exchange Act and provide the necessary leadership to assure to progress which is both real and prompt.

There are, however, some encouraging signals that the industry has begun to perceive its responsibilities. In response to the Commission's contemplated action to remove off-board trading restrictions announced in June of this year, various segments of the securities industry have increased their efforts to design and implement new facilities to link markets together. Similarly, there have been experiments with various

ways to broaden protection of limit orders on a national basis and to accommodate brokers' needs to obtain more rapid access to multiple markets.

Steps are also underway to provide for communications links between the nation's market centers which will permit orders for the purchase and sale of multiply-traded securities to be sent from one market center to another when the price in the latter market is more favorable. The contemplated systems, as a technical matter, appear amendable to use by both exchanges and over-the-counter market makers. These linkage systems assume, of course, the existence of a composite quotation system so that professionals in each market center would have access to current firm quotations – with size and depth – from all participating market centers.

Although implementation of each proposals would create new and better opportunities for brokers and dealers to direct individual orders from one market center to another, the linkages contemplated fall short of the ultimate Congressional mandate. They would not seem to provide the capability to route order flow from “upstairs” to

market centers on a nondiscriminatory basis. Nor would these linkages provide mechanisms to “hit” bids and offers reflected in the quotation system without undergoing the delays and uncertainties inherent in routing orders. Finally, the proposed linkages do little to establish a national auction based on price and time priority throughout the country, or to provide universal limit order protection in an auction context.

Accordingly, further attention must be given also to weighing other proposals which, while involving certain practical and technological problems, would not have these limitations.

Seizing upon any, or all, of these initiatives would represent a significant advance for the industry in enhancing the trading mechanisms of the marketplace. I cannot speak for the Commission today with respect to whether the road to a national market system begins or ends with a consolidated limit order book facility which has self-executing capacity; or whether that road winds its way through a composite quotation system which successively, over time, develops intermarket linkage, routing, and self-executing capacities and limit order protection; or whether the system will evolve over time in

directions none of us can now fully anticipate – directions arising out of both our experience, and future technological, economic, and legislative developments. Nor can I tell you today whether the marketplace of the near future will be one that rewards those who have organized their strategies to internalize order flow. I can tell you today, however, that those who are so hedging their bets do so at the risk that large concentrated structures may be inefficient competitors in the national system that eventually emerges.

The ultimate shape and dynamics of the national market system will, of course, undergo many changes as we proceed from where we are today. Besides a disposition of the off-board trading rules, refinements in the consolidated transaction reporting system, various proposals for a composite book, composite quotation system, automated order routing and execution systems, system governance, and a national system for the clearance and settlement of securities transactions, we at the Commission must also concern ourselves with the somewhat unexpected growth of options trading and give thorough and careful consideration to the role, if any, options will play in a national system.

The '75 Amendments, moreover, significantly revise the major portions of the Securities Exchange Act which govern the functions and activities of the exchange and the NASD. In recognition of the substantial amendments to those provisions the Congress detailed a special procedure under which the Commission could review the pre-existing rules of the exchanges and the NASD for consistency with the new provisions of the Act. Through that process, over 900 rules, covering a broad range of regulatory matters, have been isolated for close examination. And, superimposed on both the efforts to draw the separate trading markets and clearing facilities into a cohesive national system and the elimination of barriers to competition and self-regulatory rules that are inconsistent with the spirit and letter of the Act, is the 11(a) mandate of May Day 1978 – a mandate which you asked for.

Each of these are moving – no, speeding – targets at which we all must take aim while proceeding toward the markets of the future. And, I cannot tell you today, with any degree of precision, what form the national market system ultimately will take, or which of the variety of proposals currently under consideration will serve as its core. Further, I

do not mean to signal today that any particular facility currently under consideration must necessarily be the first, second, third, or even fourth step as we progress toward our overall objective. However, systems which have been proposed as solutions to the problems of a national market system – if they are to survive as permanent elements of a mature system – must be tested for consistency or compatibility with the following criteria: Do they provide for interaction of all orders? Do they contemplate the linkage of all markets and marketmakers in the same security? And do they provide for and create, or tend to lead to the creation of, a truly national auction based on price and time priorities?

#### Off-Board Trading Restrictions

With regard to off-board trading restrictions – those remaining exchange rules which preclude or inhibit over-the-counter trading in listed securities by exchange members acting as agent on crosses or as principal – there is, and has been, widespread recognition that such restrictions are a significant barrier to fair competition among brokers and dealers, among exchange markets, and among markets other than exchange

markets. As you may be too well aware, the Commission has devoted considerable study since December 1975, to the consequences of removing those restrictions, and in June of this year commenced a proceeding addressed to their removal on January 1, 1978.

Since the commencement of the Commission's consideration of this issue there has been considerable controversy surrounding the Commission's proposed action, and its impact on existing structures in the securities industry. We are not unaware of the fact that some of the possible consequences of removing these rules today would be adverse, if, indeed, those consequences came to pass. But neither are we oblivious to the fact that, in other respects, removal of these rules could foster many of the objectives of the Exchange Act, freeing up competitive forces and energies in the securities industry to achieve ends which may not be achievable by other means. As an ultimate matter, I find it difficult to conceive of a national market system, as Congress envisaged it in 1975, which is encumbered by parochial, individual market-centered restrictions on the competitive process.

The issue of removal of off-board trading rules, has, unfortunately in my view, been propelled into a position of prominence and currency to the point where it has taken on a life of its own independent from the overall purposes of the Exchange Act, including achievement of a national market system for securities. Many have speculated publicly as to what the Commission's next step will or should be in the off-board trading proceeding. And, I certainly understand the anxiety and the interest with which those in the securities industry – indeed, those of you in this room – view the Commission's current deliberations and the decision we had hoped in June to make in advance of January 1st. Having made a a long-term commitment to achieving the broader objectives of the Exchange Act, however, we cannot distort that effort by quick decisions or narrow dispositions of particular issues considered in a vacuum, or risk haphazard results in matters profoundly affecting the structure and operation of the securities markets. We will proceed with all possible speed, utilizing all the resources at our command, to settle the off-board trading problem within the context of the national market system and with due regard to all the relevant factors.

We must be satisfied, in considering removal of off-board trading rules, that the various objectives of the Exchange Act will be furthered, not retarded. If we are not persuaded that removal of off-board trading rules will interfere with achievement of these objectives, or degrade the markets, considering the aggregate effects of such removal, the law requires that they be eliminated.

We will not require removal of off-board trading rules if we determine that, by doing so, we would diminish existing opportunities for investor orders to be executed without the participation of a dealer, make the execution of securities transactions less efficient than they are today, make competition between and among markets and securities professionals less fair than is now the case, or diminish the competitive capacity of all brokers to serve their customers properly. The Congress found in 1975 that these objectives are in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets. We must take action in the matter of off-board trading rules, and generally toward a national market system, in a manner calculated to serve these several objectives.

Conclusion

As I stated earlier, I believe that the challenges facing the industry make this the most important time in the last forty years for service as the Commission's Chairman. For that reason, I agreed that a five-year commitment was both appropriate and necessary if the Commission is to provide the stability and continuity in leadership which will be necessary during the transition to a national market system. We fully recognize our responsibility to do the best we can to make the future more predictable. On balance, however, the issues are of such importance, and we will all have to live with their consequences for so long a time, that some temporary uncertainty, uncomfortable as it is, is an insignificant price to pay to ensure careful and reasoned long-term decisions.