FROM AUCTION MARKETS TO A CENTRAL MARKET SYSTEM: A NEW YORK STOCK EXCHANGE PERSPECTIVE

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CHANGES in securities regulation might appropriately be the theme of this Institute or of any current seminar on securities law, because all areas of securities law are undergoing major changes. Much of the discussion at this Institute has focused on real estate investments, enforcement proceedings, professional responsibilities and liabilities, accounting problems and business combinations. I hope briefly in these remarks to focus your attention on the *securities markets* for listed securities.

The current situation is put in focus quickly by reviewing a chronology with which many of you are familiar:

Prior to December 1968 a fixed minimum commission rate applied to all transactions in listed securities on a national stock exchange.

In December 1968 a volume discount was initiated for the portion of orders exceeding 1,000 shares.

In April 1971 competitive rates were required (by direction of the SEC) on the portion of transactions in excess of $500,000.

In April 1972 the level for competitive rates was dropped to $300,000, and the SEC in its report on "Future Structure of the Securities Markets" in February 1972 recommended moving toward competitive commission rates on all orders of institutional size.

On September 11, 1973, the SEC, in announcing that it would not object to the proposed commission rate increase by the New York Stock Exchange, warned that it will act promptly to terminate the fixing of commission rates by stock exchanges after April 30, 1975, if the stock exchanges do not adopt rule changes achieving that result.

Thus, the securities industry is confronted with the definite prospect that competitive rates will be required in all transactions on stock exchanges after April 30, 1975.

This change in the rate structure of the industry has three major impacts which have been widely discussed:

(1) Experience with competitive rates above $300,000 has demonstrated a substantial loss of commission revenue, with many institutions in effect dictating rather than negotiating the rate which they will pay.

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(2) All firms are deeply involved in considering how they will price their services, with some consensus that major firms will post their rates throughout the country and various firms will price their services differently for different types of service, varying from bare bones execution to a full line of research and accompanying services.

(3) Since the fixed minimum commission rate provides a major incentive to bring traders to the floor of a stock exchange, elimination of fixed rates will create strong compulsion for broker dealers to execute transactions in the dealer market away from an exchange.

While fixed minimum commission rates have been in effect on stock exchanges, including transactions under $300,000 at present, many institutions have chosen to execute their portfolio transactions in the third market (i.e., transactions off the Exchange in securities listed on the Exchange) to avoid payment of the fixed minimum commission rate (also, in many cases, to avoid the public exposure of their transactions on the Exchange).

These developments have been accompanied by proposals for the creation of a *central market system.* The main objectives of the proposed system are: (1) to assure that all orders in listed securities are executed within the system so that each customer will obtain the benefit of the best price in the system; (2) to utilize effectively the competition within the system; and (3) to provide equal regulation of those participating in the system.

The primary steps in creating this system are *equal regulation* of all participants, a *composite tape* to include a report of all transactions in listed securities in any market, and a *consolidated quotation system* to show all quotations for listed securities in all markets.

The critical problem facing the Exchange is to maintain the securities valuation process that derives from a constant flow of orders in listed securities to the Exchange auction market between the end of fixed rates on April 30, 1975, and the beginning of a fully functioning central market system.

As long ago as March 1, 1973, the Board of Directors of the New York Stock Exchange acknowledged in a basic policy statement that competitive rates are inevitable and that they will bring a new dimension of competition to the securities industry. At the same time the Board was concerned that a central market system would not be operating simultaneously with the advent of competitive rates, and that economic forces during the necessary transitional period would present a serious threat to the viability of the auction market.

Accordingly, the Board called for requiring concurrently with the change-over to competitive rates that all trading in listed securities must take place on registered national securities exchanges. Before discussing the rationale behind this proposal, I think it may be helpful to note briefly the major characteristics of the securities auction markets.

The distinction between an auction market (on stock exchange) and a dealer market (as in the "third market") is important. In an auction market *all* orders to buy or sell securities compete, with the sale going to the highest bid and the purchase to the lowest offer in the crowd, so that a *customer receives the best available price* from all of the competing offers to buy or sell. In the auction market the securities broker acts simply as agent and receives a commission. A specialist on an exchange participates in the market to supply offers to buy or sell (for his own account)where there is an insufficient supply of offers to buy or sell. In contrast, in a dealer market the transaction is negotiated between the customer and a securities dealer at whatever price they may set, and the dealer buys or sells securities for his own account at a mark-up to provide his profit.

The major advantages to customers in an exchange auction market system for listed securities are:

(1) Equal treatment for all customers.

(2) An efficient securities pricing or evaluation mechanism in which execution of transactions on the basis of the best available competitive price at a given moment (rather than a negotiated price with a single dealer).

(3) Absence of a dealer mark-up to provide a profit for the dealer in the dealer market.

(4) Continuous markets in listed stocks, with dealer (specialist) intervention only when the supply or demand is insufficient to accommodate customer orders.

(5) Self-regulatory rules and procedures to provide efficiency of the market and safeguard the interests of investors including listing requirements for companies whose securities are listed, surveillance of the market to detect any irregular activity, and close inspection of the activities and financial conditions of members.

With these characteristics in mind it is important to note that no one today has a clear idea of what a central market system is going to look like or when it will actually start functioning. The Exchange's urgent concern, therefore, is that while we are waiting for a central market system to begin operating, the existing auction markets will be fragmented and distorted to an extent that cannot and will not permit their restoration through after-the-fact rule making.

It seems clear that, with the advent of competitive rates, Exchange members will find themselves operating in a new economic environment in which survival in many cases will depend on their ability to capitalize on the most readily available profit potential. Virtually every firm will have to reevaluate its fundamental business mix and operating structure. Obviously, there will be strong inducements to cut out all unnecessary costs. There also will be strong reasons to deemphasize marginally profitable activities, including in many cases agency business in listed securities.

We believe competitive rates will induce a significant number of firms to leave the exchanges and simply negotiate access to exchange markets where necessary. But our chief concern is that in the transitional period a substantial number of these firms will elect to conduct market-making on a dealer basis, finding that to be an economically attractive alternative to handling agency trades in the same issues.

Given the concentration of New York Stock Exchange volume in a relatively small number of listed issues and the concentration of agency transactions among a relatively small number of member firms, any substantial development along those lines would deflect a significant proportion of orders from the auction market.

Consequently, we believe it is essential to establish a bridge from the present industry structure to the ultimate proposed goal of a functioning national market system. That bridge is embodied in our proposal that all orders in listed securities be brought to the auction markets until the national system is a reality. The debate over this proposal has gone on now for more than a year.

Consequently, we have studied with particular care a recent address by Senator Williams, in which he commented on benefits which he expects will flow from renewed competition under a bill which he has introduced and which is now pending in the Senate. Senator Williams said:

> . . . . competition is the best determinant of securities prices. A true national market system will produce optimal efficiencies in the pricing of securities. All bids and offers—supply and demand—will be exposed to each other through the medium of communications systems linking all markets into a nationwide disclosure system.
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> By eliminating market fragmentation, the public character of the markets will be maximized, and those auction principles which have made the U.S. markets the envy of the world can be extended and applied to benefit public investors. Professionals will find it easier to satisfy their obliations to their customers; and I hope that this will instill a new faith and confidence in the markets.

We found comfort in Senator Williams' acceptance of the auction principle in which all bids and offers are exposed to each other. However, we would think that those views would lead to acceptance of our recommendation that all transactions in listed securities be executed on an exchange. Without such a requirement, there would be no exposure of all bids and offers to each other until the proposed central market system is fully in place and operative.

The proposal by the Exchange has been characterized by some as an attempt to eliminate competition. I want to emphasize that our proposal is not designed to eliminate firms engaged in the third market, but is intended to increase competition by requiring that all transactions by those firms in listed securities be executed on an exchange so that, as Senator Williams suggested, all bids and offers will be exposed to each other.

I hope these comments will help clarify some of the problems with which the securities industry, the regulatory agencies, and Congress are grappling. In resolving these issues and in seeking solutions to problems in the several other major areas of change in securities regulation, I urge that all participants recognize the importance of continuing frank dialogue to create better mutual understanding and to maintain the integrity and good humor of all.