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Good speech

THE NATIONAL MARKET SYSTEM:

A STATUS REPORT

An Address by

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FBA/CCH National Market
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INTRODUCTION

Custom dictates that I begin by expressing appreciation for the invitation to speak here this afternoon. However, because the prompt establishment of a national market system is among my highest priorities as Chairman, I probably would have petitioned to appear had an invitation not been forthcoming. The timing could not have been better. This conference provides a good opportunity to continue my practice of periodically expressing my views on the Commission's role in facilitating development of a national market system.

Last December, I spoke on the national market system before the SIA in Boca Raton. At that time, the issue of off-board trading rules so preoccupied the industry that little attention was being paid to the affirmative elements of a national market system. Expressing concern that the off-board trading question had taken on a life of its own -- independent from the over-all purposes of the Exchange Act, I sought to bring that issue back into perspective as part of the broader national market system mandate from the Congress.

Then, in late January, I delivered the first Gustave L. Levy Memorial Lecture at the Twelfth Annual Conference on Wall Street and the Economy here in New York. The Commission had just issued its January Statement outlining a national market system

program for the coming year and temporarily deferring further action on off-board trading rules. I devoted most of my address to the Commission's program and its particular facilities initiatives. This afternoon, I would like to give you a status report five months into that program.

In my earlier talks on the national market system, I took time to trace the history of the concept through its culmination in the 1975 Amendments which made removing impediments to and perfecting the mechanisms of a national market system for securities an express purpose of the Exchange Act. This reflected my belief that members of the industry and others, had lost sight of how we had gotten to where we are, and that it was appropriate to provide a historical perspective so that everyone involved in the process would be aware and reminded of our responsibilities and objectives -- of what the statute requires, what criteria it sets for a national market system, the Commission's responsibilities under the Exchange Act, and where we should all constructively focus our attention. Today I believe that all are

fully aware of the responsibilities imposed by the Exchange Act and, with your indulgence, I will dispense with the retrospective.

Before moving to particular developments since the January Statement, several preliminary observations are appropriate. First, I wish to express my strong commitment that our capital markets, in the words of the statute, must be "preserved and strengthened." Obviously, the purpose of the Congressional mandate to facilitate the establishment of a national market system is to enhance the quality and integrity of the markets, not to diminish them, and to insure that continued preeminenance of our securities markets. The legislative history of the 1975 Amendments is replete with this message, and the Commission has this responsibility clearly in mind.

Second, in my Levy Lecture, I said that "I believe it highly preferable that the development of a national market system be essentially an industry undertaking -- not one to be solved by government fiat." My fellow

Commissioners share my desire that the achievement of that system remain essentially an industry task. We will not displace constructive industry initiative which is consistent with the goal of facilitating the development of a national market system, but we will take affirmative action when that is necessary to carry out our statutory responsibilities, which include an obligation to ensure that industry initiatives develop in a manner consonent with national market system initiatives. We will move promptly to fill any void and will not countenance delay or footdragging in achieving the goals of a national market system.

Third, the exact configuration of the eventual national market system cannot be foretold -- not by me or anyone else. In fact, I find the notion of a "final" national market system to be somewhat misleading if it conveys the impression that the system, like a construction project, will be finished at some point. I think most interested observors now accept the view that the creation of the national market system is a process of continuous evolutionary change, a process which has begun but which has no fixed ending point. In our January Statement on the Development of a

National Market System, the Commission issued specific proposals for an interrelated group of facilities which it believes, if fully implemented, would contain the rudiments of a national market system. The remainder of my remarks will assess industry response to certain of those facilities proposals and outline the Commission's program for the remainder of 1978.

DEVELOPMENTS SINCE JANUARY STATEMENT

In my Levy Memorial Lecture, I stated that each element of a national market system -- if it is to survive as a permanent component of a mature system -- must be tested for consistency with ideal criteria of market integration:

(i) Does it provide for interaction of all orders?

(ii) Does it contemplate the linkage of all markets and market makers in the same security?

(iii) Does it provide for and create, or tend to lead to the creation of, a truly national auction based on time and price priorities?

I continue to believe that national market system facilities, separately or collectively, in their ultimate configuration, must meet these criteria. Of course, because these facilities must be developed and implemented over time, and need to be adapted to changing circumstances, it is important to recognize that, as a practical matter, no single facility, especially in its initial form, will necessarily satisfy each of these measures of conformity with the national market system ideal.

Market Information Systems

Within the next few months, the two principal market information systems which have historically been associated with a national market system -- the consolidated transaction reporting system and the composite quotation system -- will finally be fully operational. Although certain aspects of these systems will require continuing refinement, they will provide reliable quotation and last sale information for listed securities commanding national investor interest on a current basis from all markets in which these securities are traded.

The Commission expects to issue shortly a comprehensive release on the consolidated system, proposing certain amendments to Rule 17a-15 and dealing with the specific matters referred to in the January Statement. While the consolidated system is working well, it can be improved and must continue to evolve as an integral part of the national market system.

For some time, the exchanges and the NASD have been making technical preparations to implement the quotation collection and reporting procedures necessary to comply with the composite quotation rule adopted in January. Several regional exchanges are in the process of installing systems to automatically update their displayed quotations. In addition, steps have been taken to form a Consolidated Quotation Association to provide a single data stream of quotations from participating market centers through the facilities of SIAC, the processor for the consolidated system. Among other things, the CQA quotation stream will avoid possible sequencing disparities and duplicative data transmission facilities. The CQA represents, in my view, precisely the kind of joint industry action necessary to assure the prompt development of efficient national market system facilities. I commend this initiative and encourage all market centers to join the CQA.

In April it became apparent that preparation for joint implementation and installation of new facilities could not be completed by May 1, the original effective date of the quotation rule. Accordingly, the Commission deferred its effectiveness until August 1, upon the express understanding that the market centers would continue to act with all possible speed to achieve this objective.

Market Linkage Systems

I would like to turn now from market information facilities to market linkage systems -- systems which bear more directly upon integration of our markets and upon the handling of orders in those markets. Progress in this area, while far less advanced, is now visible. In this regard, commencement of the Intermarket Trading System represents an important contribution to the objective of linking all markets in an efficient manner. An additional necessary step toward achieving both a fair field of competition for market makers and the practicability of brokers executing customer orders in the best market, however, is the establishment of an efficient communications link between brokers' "upstairs" offices and all markets for qualified securities. Today only limited versions of such an order routing mechanism exist

-- and, generally speaking, each such system is sponsored by and services only one market center and can be accessed only by the sponsoring market center's own members. No national market system is truly "national" until all qualified brokers are efficiently linked to all markets in a neutral, non-discriminatory fashion. Available technology must be employed to assure open access for all brokers and the opportunity for all market centers to compete fairly within a national market system.

1. ITS. In April, the Commission provisionally authorized the American, Boston, New York, Pacific and Philadelphia Stock Exchanges to implement an intermarket communications linkage -- the ITS -- pursuant to a joint plan. The Commission noted in its order that the ITS appears to provide the basis for the intermarket routing portion of the comprehensive market linkage system called for in the January Statement. The ITS pilot phase began on April 17 with trading in 11 issues between the New York and Philadelphia Stock Exchanges. On May 22, the number of issues was raised to 25 and for the first time ITS quotation information included size. The ITS

participants also plan to increase the number of stocks traded through the linkage as new market centers are added. The other participating exchanges will be phased in beginning with the Pacific currently scheduled for June 26, and followed by the Boston and Midwest in July and the Amex by August 1. While a meaningful assessment of the market structure impact of ITS must await the inclusion of the remaining participants and the addition of the other multiply traded isssues, initial experience indicates that the system is operating well as a technical matter and ITS orders are being accommodated on the floor of the receiving exchange without disruption of normal trading.

The principal regulatory question raised by ITS at this point is whether, and under what circumstances, those market centers which have not agreed to participate should do so. The NASD last month rejected ITS participation, citing the lack of economic incentive. In addition, the Cincinnati Stock Exchange has apparently made no effort to join. The Commission continues to believe that it is important that all market centers be linked into a national market system. However, the timing and precise nature of that linkage will depend upon the

types of facilities that are available from time to time and the usefulness of those systems to securities professionals. Thus, the industry needs to consider the technological advances and concrete proposals made by the various market centers and to recommend which facilities, proposals or combination of facilities and proposals best meet the dual objectives of ensuring best execution and promoting competition both within and among markets.

2. The Cincinnati Experiment. In addition to the ITS, the Commission in April also authorized a nine-month pilot program of the Cincinnati Stock Exchange, using the Regional Market System technology referred to in the January Statement. The Cincinnati program contemplates a multiple dealer trading facility permitting Cincinnati members and participating specialists on other exchanges to enter principal and agency orders for up to 200 multiply traded securities. Those orders would be automatically executed within the facility in strict accordance with auction principles.

The Commission has emphasized that the Cincinnati pilot program, while limited in scope and duration, should provide an opportunity for experimentation without the risks attendent to massive Commission-mandated changes in the existing structure of the markets. The information to be gained from the experiment, of course, necessarily will be a function of the willingness of other market centers and the broker-dealer community to take part in the exercise. In that regard, I think it important for the Commission to understand the business reasons which lead markets and firms to reject participation.

Concern has been publicly expressed that the Cincinnati proposal is nothing more than the proverbial wolf in sheep's clothing; in other words, a "black box" masquerading as an exchange. The very mention of that phrase seems to mobilize reflexive resistence. I am not so much concerned with the success or failure of any single facility as I am with the fact that the securities industry has seemingly expressed a preference for relying upon fear of the unknown rather than knowledge gained through experimentation.

I think that the Cincinnati experiment should be viewed as an opportunity for the Commission and the members of the securities industry to observe the effects of trading by various types of market makers, including upstairs market makers, in geographically separated locations linked together through an electronic system. That experience should help define the possible applications of the technology underlying that unique facility to the problems at which the idea of a national market system is directed. When viewed in that light, I think the Cincinnati experiment is consistent with the Exchange Act and deserves an opportunity to succeed or fail on its own merits.

3. Message Switch. In addition to intermarket linkage facilities such as the ITS, the January Statement called for a second type of market linkage facility that would permit any broker-dealer to route orders for a qualified security from its offices directly to any market trading that security. This order routing facility is commonly referred to as a "message switch." The Commission requested that the self-regulatory organizations respond by April 15 as to their willingness to undertake development of a comprehensive message switch, open to all brokers and reaching all markets. Those responses generally expressed a positive attitude toward enhancing order routing capability between brokers' offices and the various market centers, although they differed somewhat in approach and specificity.

The Commission has received two different switch proposals. The NASD submitted a proposal for a national order routing system that would constitute, as I understand it, the primary means for routing orders to the various market centers. The NASD system would be the center of a single communications network connecting all broker-dealers and market

centers. The second proposal, submitted by the New York and concurred in by the Amex, suggests that their existing Common Message Switch facility be adapted to provide the type of order routing capability referred to in the January Statement. The New York proposal, however, contemplates the continued existence of multiple, competing switches and appears to assume that the modified Common Message Switch would continue to handle only a relatively small part of total message traffic. In addition, the New York indicated that provision of computer-to-computer interfaces with automatic pricing systems, such as COMEX on the Pacific and PACE on the Philadelphia, was not now part of its proposal.

Because of the importance of order routing to providing effective competition among markets, the Commission is considering requesting further comment on the NASD and New York approaches to a switch facility. Among the types of questions we believe need to be addressed are the following:

Should order-by-order routing to the best market in size shown in the composite quotation system be a characteristic of a national market system? A corollary question is whether any order routing system not having the capability of assuring efficient order-by-order routing should be permitted to be used by a broker to transmit orders for qualified securities in a national market system? In addition, we need to consider whether, if order-by-order routing is determined to be a national market system characteristic, either the NASD or New York proposal contemplates a message switch capable of efficient order-by-order routing? Alternatively, if it is suggested that order-by-order routing should not be a characteristic of a national market system, it is necessary to ask how orders should be processed to assure that the national market system goals of fair competition among markets and "best execution" of customer orders can and will be achieved?

Since this conference provides an excellent opportunity to explore these questions, I will express my belief that the question of order-by-order routing, however resolved, is fundamental to the direction of a national market system.

The Central File

The third national market system facility identified in the January Statement is what the Commission has termed a Central File for public limit orders. In that statement, the Commission described the mechanism as one which would queue public limit orders for execution in accordance with auction trading principles and would assure that those orders are executed before any other order in any market at the same or an inferior price. The Central File, while simple in concept, most nearly meets the three national market system criteria I mentioned at the outset of my remarks. It would contribute to the interaction of all orders and the linkage of all markets, and would ensure a truly national auction for public limit orders. Moreover, the Central File represents the first concrete facilities proposal for simultaneously advancing all five of the national market system goals

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articulated by the Congress in Section 11A of the Exchange Act--goals which appear almost mutually exclusive in the context of the existing structure of our securities markets. I recognize that it is also our most controversial facilities proposal.

We requested that each self-regulatory organization advise the Commission by May 30 of its willingness to undertake joint development of a Central File in accordance with the principles expressed in the January Statement. While we have not yet received all of those responses, we have already been presented with two rather different views on how to achieve the objectives underlying the Commission's Central File proposal. The NASD included a "national limit order file" specification in its Technical Plan submitted in April, which also covers a consolidated quotation data stream and a national order routing system. The NASD file proposal is at least partially responsive to the Commission's request; but the NASD's reservation of judgment on crucial issues associated with operation of a Central File leaves it unclear whether the NASD believes the system should be constructed and whether it should function in the manner contemplated

by our January Statement. If constructed, the NASD facility would build upon the existing NASDAQ System, as well as the NASD's proposed order routing system, to provide some form of national protection for limit orders against executions anywhere in the country.

The New York Stock Exchange, on the other hand, has rejected the idea of a Central File based on its view that adoption of the proposal to implement such a File would lead "inexorably" to purely electronic trading with the consequent destruction of exchange markets. In place of the Central File, the New York recommends that market centers automate their separate limit order books, share limit order information and encourage, but not require, protection of limit orders residing in other market centers.

The Commission is now analyzing both the NASD and New York proposals to assess their consistency with the particular statutory objectives associated with a national market system. As a preliminary matter, however, both proposals have many salutory aspects. For example, the limit order storage and execution mechanism which the New York

proposes to construct contemplates entry of limit orders directly by its own members and from other markets. In addition, the Securities Industry Automation Corporation, which would be performing the development work on the New York automated book, has offered to make that technology available to other market centers -- thereby creating the possibility of compatible, although competing, books. This development would be a useful technological innovation and, as such, would not be inconsistent with our January Statement.

The New York proposal does not, however, appear to contemplate the type of national auction contemplated by the January Statement. Whether the type of facility the New York contemplates is adequately consistent with creating such an auction is a question of fundamental importance which will be addressed by the Commission once we have had a chance to receive the views of the other market centers as to whether the Commission's proposal for a Central File represents the most effective manner of meeting the goals of a national market system.

The Goals of the National Market System

From my remarks thus far, you would correctly infer that the Commission's emphasis, at this point in the development of a national market system, is on facilities, the "brick and mortar" necessary to provide market information, create market linkage and establish nationwide limit order protection. We must not lose sight of the fact, however, that these facilities, as I mentioned earlier, are not themselves the goals of a national market system, but rather are mechanisms to enable the securities industry to achieve those statutory goals. For the securities customer using the national market system, the immediate goal is "best execution," with enhanced competition among markets and interaction among orders to assure that the best execution available is at the highest price anyone is willing to pay or the lowest price anyone is willing to offer.

Traditional agency principles have long imposed on brokers the obligation to obtain for their securities customer the best price possible "under the circumstances." With increased market fragmentation in listed securities, and the correlated limitation on order interaction, the problem with "best execution" became the "circumstances" which operated, as a practical matter, to limit effective

enforcement of the broker's duty. One important purpose of the Commission's national market system effort is to contribute to "best execution" by providing the means for achieving the statutory goal of assuring "the practicability of brokers executing investors' orders in the best market," wherever that may be.

As we progress towards a national market system, the available means of securing the "best execution" of a customer's order will be enhanced with each new development. The Commission will pay increasingly close attention, in the coming months, to the manner in which those enhancements are used by brokers seeking to fulfill their fiduciary obligations to their customers.

Other NMS Issues

There are, of course, other national market system issues now being addressed by the Commission, in addition to those relating directly to the system facilities I have been discussing.

1. Off-Board Trading. As you are aware, the Commission's national market system program is being conducted in the midst of its continuing proceeding on the remaining off-board trading restrictions. One year ago, the Commission proposed to eliminate the remaining restrictions on off-board trading. In the January Statement, the Commission announced it

was deferring consideration of that proposal until later this year so as to evaluate industry response to the initiatives discussed in that statement.

While public discussion of Rule 390 has largely subsided, I need not remind you that resolution of this important issue is still very much with us. A functioning national market system should eliminate most, if not all, of the fears and concerns which were expressed during our August off-board hearings concerning the effects of removing off-board trading rules. Our program for that system was published five months ago, and most of it can be implemented in the reasonably near future, if the industry is willing to to undertake the kind of concerted joint action necessary to assure its prompt achievement.

2. Qualified Securities. The Commission also intends to initiate shortly a rulemaking proceeding for the purpose of designating certain categories of securities as qualified for trading in a national market system. While the Commission is still considering the matter and will not meet its target of issuing a release on this subject by June 30, I think it clear that some number of equity securities currently traded

exclusively in the over-the-counter market will, because of their national investor interest and other characteristics, be included in the "qualified" category. The Commission's proposal will solicit comment on a number of important issues associated with this question, and it is probable that we will propose alternative standards for comment.

I would like to take special note of the constructive attention that the NASD has already given to this important aspect of the national market system. The Commission recently received a formal submission from the NASD recommending specific standards that would result in designating approximately 1400 over-the-counter securities as "qualified." While it would be inappropriate for me to comment on those recommended standards in view of our impending release, I wish to commend the NASD for its initiative in this important area.

3. Clearance and Settlement. The Commission also continues to pursue the development of a national system for clearance and settlement. Full implementation will reduce overall clearing costs for members of the securities industry -- which the New York Stock Exchange recently estimated will result in annual savings of some

$12 - 17 million. In addition, the establishment of a national clearing system with full interfaces among all clearing agencies will permit brokers to direct customer orders to the best market without regard to particular clearing arrangements provided by that market. The requirement to clear through the agency affiliated with the market of execution historically has impeded "best execution" of orders.

Unfortunately, the development of the national clearing system has not progressed as quickly as the Commission had initially anticipated. Accordingly, the Commission held extensive public hearings this spring to explore the problems which have frustrated efforts to further development of the national clearing system. Following those hearings, the long delayed over-the-counter interfaces with two regional exchange clearing agencies were finally established -- a significant step forward. The Commission now is reviewing the voluminous transcript of the hearings with a view toward taking whatever action is necessary to assure that implementation of a national clearance and settlement system, a crucial adjunct to our national market system program, proceeds promptly to completion.

CONCLUSION

That is my status report on progress toward a national market system. One year ago, in announcing its proceeding on off-board trading rules, the Commission expressed its disappointment at the lack of progress by the private sector in achieving the type of linkage of markets, integration of order flow and enhanced competition envisioned by Congress in enacting the 1975 Amendments. Since that time, the industry has displayed rekindled interest in solving the problems associated with developing a national market system and in taking affirmative action to create the facilities necessary to make that system a functioning reality.

I have reviewed the considerable and constructive industry activity in the five months following the January Statement. My major concern at this time is that, apart from the progress represented by the ITS and the nascent Consolidated Quotation Association, so much of the industry response to the January Statement has taken the form of independent, uncoordinated initiatives by individual self-regulatory organizations. A fragmented approach to implementation of the national

market system by the self-regulatory organizations was forseeable in the early stages of responding to the ambitious time schedule set forth in the January Statement. If continued, however, it can frustrate prospects for rapid progress in the future. The industry must recognize that the time has come for the self-regulatory organizations and other interested parties to get together and jointly bring coherence and common direction to these largely uncoordinated initiatives. To the extent necessary or useful, I am prepared to participate personally and to commit the resources of the Commission's staff. In whatever way proves most effective, commitment to joint action is now crucially important to bring the initiatives announced in our January Statement to fruition.

The past decade has seen the industry struggling to survive a series of events which have profoundly altered its composition and manner of doing business. While these developments have preoccupied the industry and their effects continue to be felt, I sense the securities industry has regained its balance and is now prepared

to move constructively in creating the national market system. We must bear in mind the crucial role the securities markets play in the social fabric of our nation. Those markets channel vital capital from private hands into the achievement of our national priorities -- the creation of jobs, the production of goods and services and, ultimately, the establishment of economic security for our citizens. In that sense, the securities markets operate at the heart of our society. Those markets must continue to be -- and be perceived as -- the fairest, the most efficient, the most open, and the most liquid anywhere. Nothing in the linking of those markets into the national market system envisioned by the Commission is inconsistent with those objectives -- indeed, it furthers them fully. Thus, the Commission and the securities industry continue to have a common goal: to seek to maintain our capital markets as the most prominent markets in the world. I am confident that we will succeed in achieving that goal.