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THE CENTRAL MARKET SYSTEM:

~~Some Practical Considerations~~

An Address By

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It is always a pleasant task to talk to members of the Securities Industry Association, particularly in my home state of California. However, I must confess that I would be far more pleased to stand before you in an atmosphere of great optimism and prosperity for the securities industry. The securities business is -- and has been for some time -- in a difficult period of transition. It would be pleasing if the restructuring of the securities markets aimed at establishing a central market system could occur in more tranquil times. In my view, however this system offers great hope for the industry in this period when change and transition are, in any event inevitable, and I would like today to touch on some of the questions which have been raised by those of you in the business and try to deal with them.

As you know, the central market system involves, at least initially, linking together the existing market centers for listed securities. The two basic elements of this nationwide communication system are a composite tape for reporting the last sale information and a composite quotation system. These two fundamental elements, together with ancillary facilities, would enable a broker with an order for a listed security to quickly find and go to the best market. Rather than speaking to the theoretical factors and the regulatory principles of this system, which are covered in detail in our Policy Statement on the Structure of a Central Market System, I want to explore with you questions on some of the more practical aspects of the system. These questions include: When will the proposed changes take place? What will the system look like? How much will it cost? Who will pay for it? These are questions that both people in the business and investors properly have begun to ask.

Before getting down to these practical points, I would like to venture a general observation about tapes and quotation systems. The tape has been a symbol of the exchange markets for many years and we are all familiar with the dissemination of quotations either by telephone or more recently by NASDAQ. These familiar devices serve two somewhat distinct purposes. They are, first, a disclosure system by means of which brokers, dealers and investors can observe what is currently going on in the markets. But they also serve a function which I think is very real, although it is not so often commented upon. They are an advertising medium, and a powerful one, by which markets and market makers bring to the attention of prospective users the services which they have to offer. I suspect that it is partly for this latter reason, as well as from a committment to full disclosure, that the various markets have gone to great effort and expense to make their tapes and quotation systems available in every city and town from coast to coast. When, therefore, we consider the composite tape and the composite quotation system, we are talking not only about improved disclosure, but also about who will be allowed to avail themselves of this advertising medium and how and on what terms. Resolving these questions fairly and without discrimination has created many of the problems which have been encountered in activating the superficially simple proposal of a composite tape and a composite quotation system.

Turning now to the nuts and bolts, the first is the timetable. As many of you know, the composite tape for reporting last sale information will be the first element of the system to go into operation. The Commission in recent weeks submitted its comments by letter to the New York and American Exchanges, the NASD and the regional exchanges involved in putting together a composite tape plan last March. We expect a response to our comments shortly. We will then proceed to declare the composite tape plan effective, with whatever changes appear necessary. Once that happens, the clock will begin running on a 40-week implementation period, at the end of which we expect to see an operating composite tape. Before the tape starts operation, we will propose for comment and adopt a revised uniform rule to govern short selling in all markets, including in the third market, where short sales now are unregulated.

The second element of the central market system, which may well be at the heart of it, is the quotation system. Work on the quotation system at the Commission began more than a year ago.. We published in March of 1972 a proposed rule 17a-14 under the Securities Exchange Act covering a bid-asked reporting system for listed securities. Since that time, we have had a very significant amount of information and opinion -- from the industry advisory committee on market disclosure, from the reports of two Congressional studies, and other sources.

The final timetable as to the quotation system is presently not so clear. I suspect that we, and by we I mean not only the Commission but also the industry and its regulatory bodies, have a variety of what is called the "chicken and the egg" problem. Some suggest that before fully implementing the composite tape and particularly the composite quotation system, we should have in place essentially the full regulatory scheme for the central market system. Others suggest, with at least equal plausibility, that we can hardly design a regulatory scheme until we have first seen what the animal we are going to regulate looks like. I think the two programs will have to proceed, to a considerable degree, in tandem. The quotation system will not be implemented until after the composite tape has been in operation for some reasonable pilot period. Prior to impelementing the quotation system, we will need some regulatory mechanism to give substance to our conclusion that the privilege of entering quotations in the system must carry with it a responsibility for the fairness and orderliness of the market in the securities quoted.

The issues involved in determining these responsibilities were discussed at some length in our Policy Statement on the Structure of the Central Market System of March 29, 1973 and I will not repeat that discussion here. Under the existing system the specialists on the primary markets, the New York Stock Exchange and the American Stock Exchange, occupy a pivotal role in the market and are subject to a rather elaborate regulatory system. Specialists on the regional exchanges and third-market makers have a less central position and are less regulated. With a composite tape and a composite quotation system, these market makers will come more directly into the mainstream, and regulatory changes will be called for. This raises the issue, indeed, it may almost be called the slogan, of "equal regulation" and the opposing argument that "equal regulation" of people in unequal positions is itself inherently unequal. I do not have all the answers now. The Policy Statement said that the exemption from Rule 11b-1 now enjoyed by the regional exchange specialists would be rescinded and that the NASD would be asked to provide for further regulation of third market makers "in a manner as nearly comparable to the regulation of specialists as circumstances permit." This could mean as a minimum, that the markets made must be reasonably continuous and orderly and that the trading rules referred to in the Policy Statement must be observed. This, of course, would make it necessary to adopt trading rules of this sort prior to implementation of the composite quotation system.

These include rules designed to preserve the best elements of the auction market and those designed to protect limit orders throughout the system, to reduce market fragmentation, and to require dealers to yield priority and precedence to the orders of public investors.

Another regulatory move that would precede the operation of the composite tape will be to eliminate any barriers to the flow of orders between markets. This means the end of Rule 394 of the New York Stock Exchange, which bans exchange members from taking orders off the exchanges. We will also seek in effect a substantial increase in the professional discount now given broker-dealers taking orders to exchanges or which they are not members, so that these brokers can truly seek best execution for their customer's orders without making a financial sacrifice.

Once the composite quotation system is in operation and we have had a chance to study its operation and the impact of the regulation I have described, we will consider whether there remains a regulatory justification for rules of the New York Stock Exchange and American Stock Exchange which now bar direct dealing between specialists and financial institutions in those stocks handled by the specialists.

The next point is what will the new system look like and what changes in procedures will be required. As to the composite tape, it is outlined by the joint plan of the exchanges and the NASD. The new tape would consist of two streams of last sale prices corresponding roughly to the New York and American exchange tapes. The first data stream would consist of all trades, wherever they occur, in stocks listed on the New York Stock Exchange. The second stream would show trades in all stocks listed on the American Exchange and some selected regional listings. Symbols would identify the markets where these trades took place when not on the New York or American Exchanges. In addition, broker interrogation devices would be programmed to show the last sale in a security traded through the central market system.

Of course a number of changes in existing procedures would be required to make the tape functional. However, I don't think these are as sweeping or as far-reaching as you might imagine. For example, the NASD, which currently does not report over-the-counter transactions on a real time basis, would have to reprogram its system as to listed securities to make real time collection of this information possible for input into the tape and for interrogation purposes. In addition, some of the regional exchanges may have to improve their reporting procedures so that all trades can be reported within the time limitations required by the system. But I think it is fair to say that the brokerage firms and the great majority of investors will see very little change in the reporting of trades.

Once the tape has begun operation, the impelemntation of the composite quotation system will follow. As many of you have sensed, the concept of the quotation system is similar to the NASDAQ system we now have in use for over-the-counter quotations, although the central market quotation system probably will contain refinements not yet available in NASDAQ. For example, each market maker could display the size of the market being quoted. The system would also be capable of distinguishing, perhaps with a symbol, between public and non-public orders in order to provide for the functioning of the public preference rule in the system. That would require dealer interests to better any public bid or offer before effecting a transaction with a public customer, thus giving up precedence based on order size and priority based on time of entry.

Let me turn to the equipment involved in the composite quotation system as it will affect the various people in the order flow.

First, market makers. Specialists and other market makers will need terminals with keyboards and screens for inserting quotations and keeping track of the markets in their securities. They will also need new programming to enable this equipment to perform its function. A program to provide these terminals already is underway at the New York Stock Exchange. Some other exchanges already have terminals capable of performing these functions, or are planning to install them. Non-exchange members, primarily third market makers, already are in a position to use their existing terminal equipment so only minor software changes probably will be required for these dealers. I want to emphasize that at this point it does not seem that the central market system will require any significant investment in equipment for market makers that has not already been contemplated, although substantial programming may be required.

Less sophisticated terminals will be required for registered representatives who deal with customers but are not responsible for executing orders. They probably will need only a device capable of displaying last sale information, which they now have, or at most a simple terminal containing a representative bid-ask, comparable to what you see on Level 1 on NASDAQ. Traders or order room personnel will need more complete terminals, but many of these already are in existence and operation. However in both cases, software or programming changes will be required.

The system, of course, will have to be serviced by a main computer in conjunction with several satellite computers. Surveillance equipment will be required for monitoring, but again there seems to be little reason why existing facilities cannot be adopted for this purpose.

This brings me to the question of costs. Costs there will certainly be. For example, the system will require a central repository for limit orders, which represents the only means of assuring system-wide limit order protection to all investors. Initially, access to the limit order information in the repository would be obtained through specialists. They would probably be able to use their quotation system terminals for this purpose. It also appears that the repository would be able to make use of the memory and storage facilities of the quotation system's computers. Of course, the repository would only have to be utilized when a transaction is proposed to be executed away from the current market price. The executing broker would present the proposed transaction to a specialist chosen by him who would in turn key the transaction into the system. The screen would then display all intervening limit orders in other markets which would have to be satisfied before the proposed trade could take place.

We believe that the limit order repository could work very smoothly, and, as I have just noted, should not involve any investment in additional equipment, although it could involve significant programming costs.

The other important implication of the quotation system is in the operations area. Once brokers are able to obtain current quotation information from all applicable markets, they will then face the problem of directing orders to the appropriate market for execution. Obviously, this may require significant modification of the entire order-handling process, at least for large retail firms which have automated the order-switching process. Again, I believe the costs associated with this effort primarily will involve programming changes for these firms, not outlays for new equipment.

I cannot put a dollar sign on all this, but there are several points to be kept in mind.

In the first place, it seems that most of the hardware and much of the communications equipment that the new system will require is either already in place, or is being installed or designed in order to serve immediate needs. Thus, as I mentioned earlier, the New York Stock Exchange already has under way a program to provide new terminals for specialists. To the extent that the industry chooses to make the maximum use of existing facilities, however this may offend those who pride themselves on the facilities they have developed for their own purposes, the greater will be the reduction in the costs to be incurred to establish the central market system. In other words, I believe the industry should think long and hard before deciding to start all over again from scratch. I do not think the industry can afford this mistake.

Secondly, the changes to be effected will be for the customer's benefit; and I think the customer will be willing to pay if he knows he is paying for better service, which is more comparable to that currently available primarily to large investors.

Thirdly, we are talking about an area in which the broker has not only an opportunity to better his service but a duty to do so, once the proper tools are at his disposal.

Finally, we may very well find, particularly as we look ahead to the locked-in trade and automated clearance and settlement, that before long cost savings may begin to outpace added expenses. Thus, the broker-dealer may be enabled to offer not only better services but to provide them at lower costs. The transition will not be easy but I think the industry realizes by now that the use of modern technology to improve its service is necessary to its future.