REFORM OF THE SECURITIES MARKETS: THE NEED FOR COOPERATION

An Address By
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Preparing remarks for this occasion has been a puzzling task. I was asked to speak about legislation and related matters, which is surely timely, but it has not been exactly clear whether there was going to be any legislation this year. While Harvey Pitt and I worked on alternative drafts and tried to stay loose, I determined at least that I was going to do my best to show grace in victory -- if that should appear to be the situation this morning -- and patience, if not quite joy, in defeat, if necessary. It would have been more fun to demonstrate the former, but for that we may have to wait till next year. In the interest of all of us and the country, I hope you will join me in striving for composure. There are those who may tempt you otherwise.

For example, some weeks ago, Lee Pickard, the Director of our Division of Market Regulation, and I were both in Scottsdale, Arizona, attending the annual meeting of the National Securities Traders Association. There, on a Monday morning, we found the usual free copies of two of the

weekly securities news services under our doors. The lively topic of the moment was the consolidated tape and the problems the Commission and the tape participants were encountering in getting the pilot phase going.

In this connection, one of the services reported that Garrett was so suspicious of the New York Stock Exchange that he had ordered Pickard to take special measures to make sure that the tape would not be sabotaged.

Lee and I read this with some amazement. It seemed to us that we were the final experts on the accuracy of that report. I was certain that I had given no such order to Lee; he was equally certain that he had received no such order. And, neither of us had been consulted prior to the publication of that particular story to find out if it was true. All of which led Lee to observe, "You know, there never would have been a Spanish-American War if it were not for certain elements of the press. And we don't need another Spanish-American War." I agreed.

I am, in general, favorably impressed with the quality of the news coverage we receive, both in the daily financial press, and in the weekly business periodicals. The news they provide is extremely useful to all of us. But, I hope I am not violating the First Amendment in observing that some of the services tend to have a proprietary interest in controversy.

I know that it makes great copy if Jim Needham and I, or others in the industry, start calling each other dirty names or, to take a far-out hypothetical,

if we start threatening to meet each other on steps belonging to some square named Foley.

We at the Commission, at least, are determined, however, to keep the temperature as low as possible. We have hard decisions to make, and we want to make them possessed of the best information and statements of views obtainable, dispassionately and with cool heads. I hope and trust that members of the press will be especially careful of their facts before printing material likely to arouse anger and resentment, as most of them are already, and I urge that, when you read that we have said something outrageous, you will double check before launching a retaliatory strike.

We cannot reach satisfactory results in an atmosphere tainted with mutual suspicion and recrimination. If we start playing "chicken" with one another, proving just how stubborn we all can be, unfortunate things will happen, and people will be hurt unnecessarily. We have come close to such a state of affairs in regard to H.R. 5050.

I cannot object to the demonstration that the securities industry is learning how to make its views known, and its presence felt, before Congress. An industry so important to our economy, and so frequently misunderstood by the populace at large, should get organized in these matters. But a frantic, last minute effort to kill H.R. 5050, after all the days and years of study, comment, testimony and negotiation that went into its final form and overwhelming approval by the members of the substantive committee that

worked so long and hard upon it, all by a parade of horrors to scare the members of the Rules Committee, whose exposure to the bill is necessarily brief by comparison, while successful, may well be more harmful than helpful.

I presume that most of the opposition to H.R. 5050 was focused on that provision that would mandate the unfixing of commission rates on May 1, 1975, unless the Commission exercises the rulemaking authority given to it by the bill to extend the date for up to 18 months. This provision represents a compromise between the original version of the bill, which would have denied us any flexibility in the matter, the views of some of the industry spokesmen, who would have preferred a clear mandate the other way, and the views of the Commission, which favored leaving the matter to us and our discretion as to whether and when. No one got exactly what he wanted.

Of course, I appreciate the tactical differences between the present state of the law and 5050. The opportunities for extensive delay in the appellate courts may appear greater if we adopt proposed Rule 19b-3 under the present statute than if we merely decline to extend the date under 5050. Perhaps this is a great advantage to one whose last-ditch attitude is such that every additional day of grace is worth any cost to achieve. But to me it is, at best, a heroic, but terribly expensive, rear-guard action in a lost cause.

It seems clear to me that fixed commission rates are doomed. The question is who will kill them and when and under what conditions. It could

ultimately be done because of pressure from those among you who favor their demise, though this admitted does not seem likely any time soon. It could be done by Congress although apparently not by this Congress. It could be done by the Commission, as also appears sure if not quite absolutely so. Or it could be done by the U.S. Supreme Court, now that it has accepted the Gordon case for review.

The best way would be the first, but it takes too long. The worst way, in my opinion, would be the last. We strongly support the reasoning and conclusions of the Court of Appeals for the Second Circuit in Gordon, namely, that exchange rules and Constitutional provisions subject to our jurisdiction under the Securities Exchange Act may not be the subject of a direct action under the antitrust laws. We have fought this battle on- many fronts and will continue to do so. We think this is the correct view of the law, and we do not think the securities industry needs exposure to treble damages.

If you study the release proposing Rule 19b-3, you will see that it is consistent with this approach. We have carefully refrained from maintaining that fixed rates are, and always have been, illegal or inherently wrong. It has sometimes been suggested that we are being unreasonably reasonable. If we simply take down the antitrust "umbrella," as some phrase it, and declare that fixed rates are not, and have never been, necessary to make the Securities Exchange Act work, we could just let you run for cover. But we do not think that is good law or good administration, even if it would work. Our position is that changed market conditions, especially the increased institutionalization

of trading, have produced circumstances in which fixed rates will no longer be the appropriate course.

This may not necessarily persuade the Supreme Court, but we think it should.

Being of the view that unfixed rates are the pattern of the future, we considered the alternatives. Wait for Congress or the Supreme Court to resolve the problem. Or wait for other market developments to occur, both structural and financial, in an effort to hit that magic moment when the least disruption would occur. We have so far concluded that the best way to get rates unfixed is to set a date and do it. Of course, we cannot do this without a hearing, nor would we if we could. Our hearings, which began November 19th, are still in progress, and won't end until later this month. It is possible that the hearing will lead to some modification of our plan, not as to ultimate objectives, but perhaps as to steps and timing of collateral measures.

In the course of the hearings, industry spokesmen are pressing upon us potential problems that may arise if, and when, rates become unfixed.

For one thing, the Midwest and Boston Exchanges have indicated their general support for the concept of unfixed <u>public</u> commission rates when certain other facilities are available, such as nationwide clearance and depository facilities, a consolidated tape and a composite quotation system.

Second, the Board of Directors of the New York Stock Exchange has likewise stated, in its formal response to our request that it unfix rates, that it does not oppose unfixed public rates, provided only that, concurrently with that action, effective legal measures are adopted to insure the preservation of our auction markets in listed securities by requiring all trades in such securities to be transacted on an exchange, or at least exposed to orders on an exchange. The stated fear is that, when fixed minimum commissions are eliminated, broker-dealer firms, that now account for a substantial portion of the exchange's business, will leave the exchange in favor of making more profitable dealer markets upstairs, unless appropriate restrictions designed to prevent this are adopted.

And third, a wide cross-section of the securities industry has complained that, in an era of unfixed rates, research on Wall Street will greatly contract, because fiduciaries will be unable to use so-called "soft-dollars" to pay for the research they now need, receive and use. It has also been argued that this would be bad for smaller trust departments, which can neither afford much in-house research nor charge higher management fees than the larger trust departments that can. How can the smaller trust department survive if it cannot buy research with commissions paid for by the accounts being managed?

Our present hearings are not yet complete, and there still are things we can learn. But, in considering all of these fears and desires expressed in relation to unfixed rates -- that there be an efficient national clearing system

and composite quote system as well as a composite tape or that trading in listed shares be confined, or at least exposed, to an exchange, or that street research will largely disappear -- we are convinced these matters could have been far more effectively handled, if necessary, with the proposed legislation than without it.

H.R. 5050 and S. 2519 made clear our authority to take the one step New York and others have urged -- to restrict trading in listed securities to exchanges. Even if we were inclined to accept that as an appropriate solution, a conclusion we have not yet reached, in the absence of the pending legislation it may prove difficult to justify our authority to take such a step, in which case we would have to seek other protective remedies.

If we require exchange commissions to come unfixed by the adoption of Rule 19b-3, our decision probably will be rendered by the middle of January. That, it seems to me, will be an appropriate time to begin consideration of what steps we might take to prevent any erosion of our auction markets.

The Commission is firmly committed to the maintenance of fair, orderly and efficient markets, and we intend to be diligent in carrying out our mandate in that regard. While I do not now think we should, even if we can, restrict nonexchange trading in listed securities unless it appears, after actual experience, the only appropriate thing to do, I do think the Commission should watch the situation carefully to prevent matters from progressing

beyond control. Our ability to accomplish these important goals will be far more difficult without the proposed legislation.

The institutional brokerage problem that many fear will arise after rates are unfixed also deserves further consideration. In the course of the August survey that we made to learn the experiences of the firms which, during July, had tried to increase rates on institutional orders and were forced to abandon the experiment because of resistance by institutional customers, many institutions and brokers told us that they would welcome a public airing of the problems relating to institutional transactions in an unfixed environment. We responded by holding a conference in Washington on October 29. We later read of some expressions of disappointment that no official conclusions were reached, which, of course, was not the purpose of the conference. Those of us on and with the Commission found it an interesting and enlightening day.

It is not at all obvious to me that, when commissions come unfixed, a portfolio manager will have an obligation always to seek the lowest execution cost at the expense of drying up his access to street research. Nor does it seem reasonable that he will be obligated to purchase street research with his own hard dollars with no adjustment in his fee.

It may also be that paying up will not be the conspicuous problem that many fear. Everyone apparently agrees that a portfolio manager, even a trust department, can reward a broker for research with greater volume of orders provided the execution is satisfactory and the execution cost is no higher --

just as they do today. So the fears are grounded on the expectation that there will develop, for institutions, a clearly identifiable rate for executions without research and another, higher rate for execution plus research, and that the rate for execution without research will be too low to enable the broker to maintain a research capability.

Maybe this will develop, but maybe it won't. If it does, then, for one thing, the aggregate execution expense of managed portfolios will be less than contemplated by the parties when the present arrangements were negotiated, and, at least in theory, the amount by which they are less should generally be available to buy research. But the differential itself may not develop in significant, measurable terms. Some brokers argue that the present cost characteristics of the brokerage business, meaning a higher proportion of fixed costs, are such that they will always benefit from more volume, at least once fixed costs are covered, and that it will be profitable to them to be rewarded for research with more volume without a higher rate for research.

At this juncture, one must say that we cannot predict exactly how it will all work out. I must add that I do not think it is necessary to be able to predict exactly how it will work out. To the extent that street research is valuable, I'm confident that people who can use it will pay for it, one way or another. If it is not valuable, perhaps we have too much of it of too poor quality.

In any event, the Commission probably cannot resolve these questions by formal action under its existing authority. We cannot even resolve them

by comfortable words in speeches. Unless the Congress preempts the matter effectively, as H.R. 5050 proposes to do, the question will remain primarily one of state law governing the duties of fiduciaries. In the absence of clear precedent, the question is one on which reasonable men, including reasonable lawyers, can and do differ.

Fixed commission rates may, at this moment, seem most important to you and the industry. But, there is much more in the proposed legislation. In all the excitement over H.R. 5050, it is easy to forget the fact that the Senate already has completed work on four major bills ranging in subject from the central market- system to municipal bond regulation. Both the Senate and House bills affirm the establishment of a national, or central, market system as national policy, and confer upon the Commission the mandate and the regulatory powers to work with the industry to bring it into being. If the legislative package before the Congress is enacted, new regulatory authority to govern institutional portfolio disclosures, transfer agents and depositories- likely will be the law. These are desirable goals which the industry and the Commission share.

We have said, many times, that a central market system -- the major focus of the pending bills -- should insure a healthier, more competitive securities industry, and it is toward this end that progress is most important. In these areas, the pending legislation may make our ability to act clearer, but it cannot and will not provide an adequate substitute for the cooperative efforts necessary to develop a central market system.

The pilot phase of the consolidated tape represents a solid step in that direction. Our proposed Rule 17a-14, which would ask the exchanges to present plans to make their specialist quotations generally available, is the next critical stage. It was not warmly received in all quarters. The New York Stock Exchange, in particular, took a proprietary attitude toward its quotes and has suggested it will decline to come up with such a plan if the rule is adopted. Some of the other exchanges and the NASD already are developing plans. So are some vendors of such information, who object to our proposal to give the exchanges an exclusive, so to speak, in presenting plans until February 1.

As to the proprietary aspect, I doubt very much that there would be any Constitutional problem of deprivation of property without due process in requiring an exchange to make its quotes available to one or more vendors. If this is all there were to the matter, I, at least, would favor going ahead and resolving the Constitutional question in court if necessary.

This does not mean that we are wholly indifferent to arguments that various measures proposed and contemplated will reduce the value of a seat on the New York Stock Exchange. For several years we have observed that this merited attention, but we think that the initiative should come from the persons most directly concerned. The New York Stock Exchange has proposed a tax write-off program, which may be the simplest solution.

But the problems are not limited to whether the New York Stock Exchange has a proprietary interest in its specialists' quotes. There is, to my mind, the much more difficult question of the proper and orderly way in which to move from here to the central market system.

First, a word about the central market system. The only comments about it that tend to irritate me are those to the effect that no one knows what it is and no one knows what it will cost. As to what it is, or, more properly, what it will be, the broad outline of final objectives has been clear for some time. The details have not been clear, and it is not a fair basis for criticism that they have not been.

Sandy Yearley's committee is hard at work on recommendations to us to help make them clear. With all of its diligence and willingness to work hard, the committee is demonstrating that resolving the detailed questions is not easy. No sensible person ever thought that it would be. That's one reason we appointed Sandy's committee.

The easiest part of the task is the technology. The computer experts tell us they are prepared to set up any system we could reasonably want, if only we would tell them what we want the computers to do. They are also prepared to give time and cost estimates, but obviously these vary according to the program to be installed.

I think it quite inappropriate to criticize the central market system program at this stage by grumbling that nobody knows how much it will cost or who will pay for it. Of course nobody knows, because the details of the system relative to these factors have not yet been agreed upon. But I hope that members of the securities industry, however much they may disagree with our judgment on specific matters, would not think the Commission so unreasonable as to order into being a system whose costs obviously outweigh its worth or that nobody can pay for.

A somewhat more complex question is the proper order of developments. We get rather conflicting opinions on how to proceed. On the one hand, are those heads of brokerage firms that urge coordination. They dread the availability of simultaneous competitive quotes prior to the availability of electronic means for seeking the best market promptly and economically. They do not want a composite quotations system at a time when their own computers automatically route all orders in New York Stock Exchange-listed shares to the floor of that exchange, and when directing an order to another market through human intervention would be costly and inefficient.

On the other hand, there are those who are not the heads of brokerage firms, but who understand how things get done. They argue that something as complex as a central market system cannot be created by mere force, by government fiat. It will only be done, or certainly will best be done, when the

people who actually have to do the work want it to happen and help it to occur. This requires an incentive, economic or otherwise.

Lacking an acceptance by key persons in the process, based on their own views of their own welfare, it has been suggested that we should generate the incentive by making the alternative painful. For example, if the Commission formally stated that best execution required of all brokers could not be satisfied routinely by execution on the New York Stock Exchange if there was, at the moment, a better market elsewhere, then the industry would have the needed incentive. So would it have if we simply required that all quotes on all markets be generally available through vendors.

My own inclination is not to achieve the central market system through scaring the hell out of members of the securities industry by exposing them to legal liability. Complex matters such as these ought to be worked out through careful study and planning. Of course, careful study and planning require a good faith effort by all participants to achieve the result, which I am confident will be forthcoming.

I know that it must seem frustrating at times, or even all the time of late, to watch the five of us in Washington, with no practical experience operating a brokerage firm or an exchange, make these major decisions. But it should help things somewhat to know that we are not indifferent to the matters that concern you, we do not have any grandiose notions of our own infallibility and we are more than willing to sit down with you -- collectively

and individually -- to fashion a viable and, hopefully, enduring central market system.

Now that the Commission, with industry advice and counsel, has defined the broad policy objectives to be achieved, the system operates best when the industry supplies the necessary technical expertise to implement those objectives. The system breaks down, however, when mistrust and antagonism take the place of rationality and cooperation. It may, at times, seem comforting to vent frustrations on symbols of oppression -- such as pending legislation. But such endeavors, aside from relieving misplaced tensions and creating new frustrations, are largely a waste of time. With or without legislation, our mandate and goals are clear, and we will achieve them.

But, if we are to achieve them in a manner calculated to enhance your best interests -- and, accordingly, to enhance the best interests of the investing public -- this is no time to draw battle lines. Our doors are open, and always will be. Our intentions are honest and should not discourage you. We can survive, and desperately need, constructive criticism. In the long run, therefore, the validity of our actions and the benefits they produce, or fail to produce, are your responsibility as well as ours.

I have devoted my remarks this morning to the immediate concerns of market structure, as I was asked to do, but we recognize as I know you do, that there are bigger and, in the long run, more fundamental matters

concerning the capital needs of this country and the capital-raising functions of this industry.

It is our hope that we can soon resolve the remaining questions of market structure so that we may concentrate our attention on these more fundamental problems.