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MARKET STRUCTURE FOR THE '80s -- THE SEC AT A CROSSROADS

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Introduction

In a recent letter to the Commission commenting on the order exposure issue, Merrill Lynch opined that "[t]he Commission is at a crossroads," with "an opportunity to make genuine progress toward the goal of a functioning national market." Two weeks ago, John Phelan, President of the New York Stock Exchange, was reported as saying that support for a national market system is dying.

What is this so-called "national market system," which generates such conflicting assessments? When I recently asked our staff to give me its specifications, they pointed out that it was not a "thing," but rather something more intangible -- a concept perhaps or a goal or even an ideal. Perhaps it was an admission that after more than a decade of proposing, proding and experimenting, the national market system continues to be more aspirational than operational, while evolving in response to the powerful forces of change in the marketplace.

The notion of a national market system was first suggested twelve years ago in a Commission letter transmitting its Institutional Investor Study to Congress. The concept was there described as "a strong central market system for securities of national importance, in which all buying and selling interest . . . could participate and be represented under a competitive regime." This definition remains as workable today as it was in 1971, despite the vast changes that have occurred.

I agree with Merrill Lynch. We are at a crossroads. The time has come for the Commission to take stock of the present status of its market structure efforts, and to restate its role and objectives in light of the changes occurring and the issues that will confront the securities markets in the 1980's.

There are four important changes that will profoundly influence the future shape and direction of the securities markets. First, there has been an explosion of trading

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volume, with institutions playing an active and ever increasing role. Average daily trading volume on the Big Board grew from 15.3 million shares in 1971 to nearly 83 million shares in the last five months of 1982. Second, the markets have responded with increased automation of both the execution and processing of trades. Third, with the growth of NASDAQ and the availability of transaction information for national market system securities, the over-the-counter market now offers an attractive alternative to exchange listing. And fourth, we see a continuing trend toward consolidation in the securities industry. The "financial supermarket" is much in vogue and, as the few remaining barriers between financial industries erode, we see the prospect of entry by banks at all levels of the industry.

In my time with you tonight, I will first review significant landmarks in the evolution of a national market system. I will then propose some principles that may help to guide the Commission in evaluating current issues of market structure.

National Market System Retrospective

In June 1975, Congress responded to the Commission's call for change by enacting the Securities Acts Amendments of 1975, which directed the Commission to facilitate the creation of a national market system for securities, consistent with broad congressional findings and objectives.

This legislation is fascinating, for in many respects it foreshadowed the deregulatory trends of today. Thus, while the legislative findings called for the broadest possible dissemination of market information, the linkage of markets, and the enhancement of opportunities for investors to receive best execution for their orders, these goals were to be achieved primarily through the cooperative efforts of the securities industry, not through direct Commission action. Encouragement of competition through elimination of barriers was the keystone. What has the Commission accomplished in response to this legislative charge?

One of the major objectives of the 1975 Amendments, the full elimination of fixed commission rates, was attained just prior to enactment of the Amendments. In the face of strong opposition, the Commission ordered the complete unfixing of commission rates by May 1, 1975, thus permitting direct competition among brokers on the basis of price, and indirectly affording institutions "economic access" to the Big Board.

Another Congressional objective was the broad dissemination of trading information from all markets. In 1976 the consolidated transaction system was implemented. It disseminates last sale information from all markets in listed stocks. Firm quotations from those markets followed in 1978.

The removal of other competitive barriers, however, proved more controversial. In 1975 the Commission eliminated most exchange restrictions against agency executions away from an exchange and in 1977 proposed to remove all remaining off-board trading restrictions. While the Commission viewed these restrictions as anti-competitive, many industry representatives feared that their removal would fragment the market for listed securities and handicap exchange specialists in competing with large retail firms. They sought to maintain the restrictions against member firms trading listed securities as principal away from the exchange floor. Instead, they urged the Commission to concentrate on linking the existing exchange markets into one national market for listed securities. There, they argued, fair competition could flourish. It is ironic, yet not entirely surprising, that many in the industry argued against the deregulatory approach of removal of barriers to competition, supporting, instead, direct Commission initiatives.

In response to Commission initiatives, the exchanges developed the Intermarket Trading System, an electronic system for routing orders between exchange floors that permits a broker or specialist quickly to access a superior price disseminated by another exchange. In May 1982, pursuant to Commission order, this system was linked to over-the-counter trading in the the NASD's Computer Assisted Execution System ("CAES"). As a result, orders in listed securities now can be routed easily between exchanges and the over-the-counter market. In connection with ITS, exchanges adopted "trade-through" rules requiring brokers to respect superior quotations in other markets.

The Commission has also supported development of the Cincinnati Stock Exchange's National Securities Trading System ("NSTS") and its linkage to ITS. This system permits firms to make markets in a fully automated system.

Finally, in 1980 the Commission adopted Rule 19c-3, removing off-board trading restrictions for securities listed on an exchange after April 1979. Rule 19c-3 was designed to free newly-listed securities from the anti-competitive effects of off-board trading restrictions, and gain experience in a limited context with the effects of exchange

member trading of listed stocks over-the-counter in competition with specialists.

These changes have made a difference in the markets. Consolidated quotation and last sale information from all markets are now widely available and contribute to efficient pricing of securities. Commission rates are set by competitive forces, not arbitrary schedules, and executions for all sizes of orders can now be obtained at prices substantially below the earlier fixed commission rates. Thousands of orders are routed through ITS daily, providing improved executions to customers in many instances. And the Commission's actions to increase competition between markets have served as a catalyst to innovation and change on the primary exchanges. By focusing attention on specialist evaluations and the stock allocation process, the Commission helped to improve exchange specialist performance. And I suspect that the specter of potential competition from large firms was a major factor in the NYSE's decision to undertake the multi-million dollar enhancements to its floor that helped it accomodate without disruption the onslaught of 100 million share days last fall. Perhaps this was what the President of the New York Stock Exchange had in mind when, at the Commission's Major Issues Conference last year, he suggested that the Commission could share some of the credit for the industry's preparedness.

I believe that, as important as these results have been, the Commission's efforts also have been useful in permitting the Commission to discover the limits of its institutional competence. We have learned that, in an industry functioning well, effective change is evolutionary change. And we have learned that, while deregulation in theory may promote a healthy competitive environment, in practice deregulatory initiatives may have to yield to direct Commission action so that competitiveness is not gained at the expense of fairness, or through radical disruption of an existing industry structure.

New Market Developments

Recently there have been a number of industry developments that raise new questions concerning the structural issues before the Commission.

First, we have the drastic surge in trading volume that hit all markets in August 1982 and has continued. One hundred million share days on the NYSE, once viewed with awe, now produce a yawn. And record-shattering 70 million

share trading days have been experienced in the NASDAQ market. Prudent planning, on the part of the clearing entities and the New York Stock Exchange in particular, had prepared the markets for growth and consequently the sharp rise in volume that struck in August was generally handled with ease. Yet, as this trading boom, sparked originally by heavy institutional trading, eventually was swelled by small individual orders, the need for automation of small order processing has grown more pressing.

Second, we have the increasingly active and creative trading by institutions. It appears that many institutions have changed their traditional investment attitudes. They now are less likely to purchase and hold; increasingly, they are active in the markets on a regular basis, buying and selling to maximize short-term profits. Stepped-up institutional purchases and sales were largely responsible for the start of the trading surge, as reflected in the record share of the Big Board's trading volume in 1982 - 41% - accounted for by large blocks. This accelerated institutional trading requires deep and liquid markets with able and well-capitalized market makers capable of preserving orderly markets in the face of extensive block trading.

Third, we have the shifting and overlapping borders of the banking and securities industries. As securities firms have striven to become complete financial centers through consolidations and mergers with non-securities entities, both financial and non-financial, the banking industry has poised itself for a broad-based entry into the securities markets. In some areas, especially the discount brokerage business, banks have already become a factor. Bank of America's acquisition of Charles Schwab & Co., Chase Manhattan's acquisition of Rose & Co., and the in-house development of discount brokerage services by Security Pacific, Crocker and Chemical Bank are well known. While these bank brokerage operations have had minimal impact so far, they potentially could have a significant effects on the securities industry and the structure of its markets. In particular, discount firms have led the way in streamlining order routing systems to provide nearly instantaneous reports of executions back to their customers. The market appeal of rapid reporting and the growing prominence of discount firms is likely to accelerate the trend toward automated small execution systems.

The entry of banks in the securities field raises among broker-dealers the broader concern that in the long term banks may choose to by-pass their securities industry competitors by trading orders derived from their huge retail

customer base and existing trust accounts outside the existing market system. This could take place through the development of an automated system that would pair-off bank orders against each other before routing the excess to an exchange. This concern, while not immediate, further complicates the question of whether orders in listed securities should be traded by members off the exchange.

Current Issues and Alternatives

In the midst of these swirling currents of change, the Commission is confronted with two major structural questions. The first is whether to require market makers to expose customer orders in Rule 19c-3 stocks, in order to provide competing markets an opportunity to improve the execution price. The second is whether to allow the Big Board to expand its Registered Representative Rapid Response System ("R4") without adding measures to provide additional customer protection. In its present form, the R4 system allows registered representatives in participating broker-dealers to confirm executions to their customers at the best quotation prior to sending the orders to the exchange.

These questions raise two deeper issues integral to a national market system. The first, broadly stated, is whether the markets for listed securities should be centralized on the exchanges, so that all orders are executed on exchange floors linked to one another, or whether the markets should be open-ended, allowing unfettered market making separate from existing linked markets. The second question is whether, and to what extent, increasing efficiency through automation of executions, particularly for small orders, should outweigh the possibility of improved prices for customers and whether increased efficiency will impair competition or the pricing mechanism. For several years the regional exchanges have operated systems that execute small orders automatically at the best quotation. These systems have harbored structural policy questions that the advent of high volume conditions and the development of R4 by New York have intensified.

Underlying these substantive questions is a procedural one: what role should the Commission play in shaping the structure of the markets for the '80s. There are no easy answers here. One can identify several possible approaches however.

A. <u>The Question of a Centralized or Open Ended Market</u>

1. One possible approach to the question of centralized or open markets is to adopt an exchange-only trading system through rescission of Rule 19c-3. This action would declare, in effect, that the benefits of a defined and self-contained market system, in which most orders are executed in linked exchange markets, outweigh the benefits of competitive pressure resulting from actual and potential competition by member firms with exchanges.

Repeal of Rule 19c-3 could be coupled with removing existing barriers to delisting. Removal of exchange rules requiring a super-majority vote of shareholders in favor of delisting would give an issuer the option of easily returning to the over-the-counter markets. Thus, it would encourage competition between over-the-counter dealer markets and the linked auction markets of the exchanges. While this competition should be encouraged, I doubt whether simply removing delisting barriers alone, without other forms of competition, would put much competitive pressure on the exchange markets. Big Board listing provides too many advantages in terms of prestige and visibility for many issuers to delist without great provocation.

2. A second approach would be to retain Rule 19c-3 and the automated interface between exchange and over-the-counter markets, while adopting an order exposure rule applicable to all markets in Rule 19c-3 securities. Requiring order exposure should integrate over-the-counter trading with existing exchange markets by ensuring that customer orders are accessible to all markets. This rule would also provide the Commission and the industry with empirical data on the effects of order exposure. Does it provide incremental benefits to the markets by improving execution of customer orders and improving opportunities for dealer competition? Or does it make trading more cumbersome and risky, effectively curtailing over-the-counter competition in Rule 19c-3 securities?

3. A third approach would be to maintain the present course by keeping Rule 19c-3 and the interface between exchange and over-the-counter markets without an order exposure rule, while continuing to monitor the trading to ensure that no harm develops. This approach would leave unresolved the larger question of the merits of a centralized or open system, while retaining Rule 19c-3 as a means of providing some incremental competition to the markets and incentives to the primary exchanges to maintain the quality of their markets.

4. A fourth alternative would be to expand Rule 19c-3 to apply to additional, more active, securities. Expansion of Rule 19c-3 to additional stocks could be important to the Rule 19c-3 experience because the stocks currently subject to Rule 19c-3 are relatively inactive, offering little opportunity to develop a potential trading profit center for market making competitors. As a result, the major firms have apparently concluded that active participation in the Rule 19c-3 experiment is not an attractive alternative at the present time. Even if Rule 19c-3 were not extended to all listed stocks, inclusion of some additional active stocks could provide increased incentives for added Rule 19c-3 market making.

And there are various combinations and permutations of these four basic alternatives.

B. The Question of Small Order Automation

As a result of the recent boom in volume and the implementation of New York's R4, the question of how the markets should be automated has grown in importance. Of particular concern is the question of small order processing. The high cost, relative to size, of individually handling small orders makes speed and efficiency extremely important. The Commission has long recognized that the automated execution systems of the regional exchanges raised, on a theoretical level, market making and pricing efficiency concerns. If enough order flow for a security were to be handled automatically, by derivative pricing without being exposed to the markets where that security trades, there is a risk that competition and the efficiency of pricing the security on those markets will suffer.

The Commission also is concerned that customer orders in these systems may be deprived of best execution, if the actual prices at which small orders are regularly executed in the markets are not reflected. Nonetheless, the Commission has not directly challenged these systems in the past because until recently they attracted relatively little order flow. They also provided the regionals with a means to compete with the Big Board, at least in some orders. While the regionals normally do not offer a better price, they provide a faster and cleaner execution than could previously be obtained on the Big Board.

New York has recently altered these considerations through introduction of its R4 system. This system, developed to compete with the regionals' automated systems, raises many of the same concerns but in an aggravated form,

because R4 could attract a much larger share of the small order flow. And the R4 system harbors more serious best execution concerns than are generally found with the regionals. Unlike two of the three regional systems, R4 provides no means for customer orders to obtain a price better than the consolidated quote, despite the fact that approximately 25% of all New York trades take place between the quote.

The automated execution systems raise the problem of reconciling execution efficiency with structural and customer protection objectives. In fact, these systems raise the question of order exposure, just as Rule 19c-3 does, but in a different context.

One approach to resolving the problem would be to design system modifications to achieve some kind of order exposure with a view to ensuring best execution. The Commission has asked the Big Board to explore this approach in connection with R4.

Alternatively, the problem could be addressed through a single small order processing system to replace the individual exchange systems, in which the various markets could enter orders indicating the prices at which they would be willing to trade small orders. Potentially, this system could act as a spur to market maker competition, while avoiding the pricing inefficiencies of derivative pricing.

Finally, the problem could be addressed without new systems through expansion of the odd-lot to include orders of over 99 shares. This would be equivalent to extending Rule 19c-3 to small orders. Because odd-lots are not subject to off-board trading restrictions, this action would allow small orders to be executed internally by securities firms. While expansion of the odd-lot might exacerbate competition, pricing efficiency and best execution concerns, it would greatly increase the efficiency of executing these orders.

Guiding Principles

In reviewing these different approaches, and their implications for the Commission's structural role in the markets of the '80s, I have attempted to demonstrate the wide range of feasible alternatives available. Arguments for and against each of these choices can readily be advanced. In trying to sort out the options, can we find guidance in the 1975 Amendments from which our mandate for a national market system derives? There one finds a number of stated objectives that often appear conflicting. We

learn that efficient executions are important, but so too are market competition and best execution. We find concern for direct interaction of orders, but also for fair competition between dealer and non-dealer markets. We find a Congressional dislike for off-board trading restrictions, but a refusal to do more than authorize the Commission to decide their fate. Underneath it all we see a pervasive concern for that perennial sweetheart, "investor protection." The 1975 Amendments are hardly a decision-tree.

In charting our course amid these confusing and at times contradictory policies, it _is_ useful to draw upon the lessons of the Commission's past experience. As the great Stuart jurist, Sir Edward Coke, said with reference to the development of the English Common Law, "out of the olde fields shall come new corne." In the same manner, principles derived from our earlier experiences should guide us in grappling with current structural questions.

I suggest that the following principles may be derived from the history of the Commission's regulatory efforts and particularly from its experiences in seeking to facilitate a national market system:

1. _The Commission should have a pro-competitive bent. It is most effective at channeling the powerful forces of private sector competition and removing unnecessary obstructions from the path. It is least effective as a systems designer, initiating major innovations on its own._

Our experience with fixed commission rates provides ample evidence of the structural impact of encouraging competition. The Commission ought to facilitate opportunities for competition by removing restrictions wherever possible, to permit broker-dealers to offer issuers and investors the broadest possible array of services. This does not mean that the Commission should attempt to force competition; only that it should remove obstacles to allow competition to develop as it will. Productive pressures for improving the marketplace can result from the potential for competition, even where competition may not currently exist.

2. _But an absolute, competition is not! Particularly in this time of surging trading volume and rapid industry change, the efficiency and stability of the markets must be considered when undertaking structural initiatives._

The marketplace is soundly rooted through layers of history. The deeper those roots, the harder it is to transplant them. We should not jeopardize the stability of a system that is already working well, or clog its efficiency,

in order to create a theoretically more perfect competitive environment.

3. It is the Commission's task not just to study and question, but most importantly to act in the long-term best interests of the securities markets.

The securities industry is characterized by a wide diversity of views; it often focuses on short-term concerns and quite properly is guided by self-interest. For each of the more difficult market structure questions, there is no single, correct solution, nor will all parties be happy with any of the possible answers within the range of what is reasonable and tolerable. Congress and the industry look to the Commission to make decisions. Thus, the Commission has a mandate as well as the authority to act on market structure issues; it should exercise that mandate decisively, after careful study. Yet it must act with predictability. To a large extent, the industry can adapt to any market structure within reason, but it cannot operate effectively under constant uncertainty as to the Commission's direction.

4. Finally, without denigrating the value of efficiency, the Commission must always be attuned to the interests of investors.

Generally, these interests will best be served by encouraging maximum competition in the markets, particularly in the array of services offered to investors. For the future, the increased substitution of institutional money managers as intermediaries between the ultimate investor and the marketplace may alter to some extent the nature of the protection that we should afford these investors. Money managers, acting for others and charged with the duties of a fiduciary, need opportunities to shop for or develop innovative services and new investment techniques more than they need protection in dealing with market-makers. They can fend for themselves. In these cases, our focus must shift to the relationship between the manager and his client. Of course, it will still be necessary to keep our securities markets safe for the individual investor and to ensure that services offered investors are based on free and fair competition, rather than unfair competitive restrictions and market distortions.

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I believe that these principles will prove useful in guiding the Commission's decisions with respect to issues of market structure.