FOR RELEASE: 1:00 P.M., FRIDAY, NOVEMBER 30, 1979

THE NATIONAL MARKET SYSTEM: AN UPDATE

Address by Harold M. Williams, Chairman
Securities and Exchange Commission

ALI/ABA Conference on
Broker Dealer Regulation
New York, New York

November 30, 1979

We are in a period of change in the securities markets. Part of the reason lies in the fact that during the past dozen years, our capital markets have been subjected to unprecedented economic and regulatory stresses which caught us largely unprepared -- a shock wave after an unprecedented period of unbelievable and virtually uninterrupted economic growth which peaked in 1968, with industry revenues of more than $5 billion. During the '60s, the economy was good and the markets even better. The average annual compound rate of return for the Standard and Poor's 500 was just under 15 percent. Until 1969, many professionals in the securities industry and many investors had experienced no other kind of market. Many assumed -- or at least hoped -- things would continue that way forever.

The 1970s, by contrast, have seen more varying economic conditions. The decade has already seen two recessions -- one of which was the sharpest and most protracted of the Post-War era -- and, as the decade closes, we appear to be in a third. Inflation -- a problem which 10 years ago many economists thought to be of minor significance, and in any event, controllable -- has proved its ability to resist both fiscal and monetary actions. Indeed, inflation -- bolstered by the lack of will to combat it -- threatens to become a permanent fixture of our economic landscape. And, as we have seen, inflation breeds recession. It reduces the profitability of American business to a level inadequate to fund its future. Business profitability overstated by accounting conventions which ignore the economic realities of inflation, causes business to limit expansion, to delay expenditures and to play it close to the vest. It erodes savings and confidence in the future. It encourages investment in what are perceived to be inflation responsive tangibles -- many of which are not liquid or readily marketable. It reduces and eliminates the growth in the national income which we look to fund our social programs and aspirations. What we have not yet seen is that inflation flames social disorder.

Another factor in our changed economic picture has been the increasing problems and dislocations resulting from the realization that the world's supplies of fossil fuels are not inexhaustible, and that in order to continue economic growth and maintain our high standard of living, and to protect our political and economic independence in the world, we must conserve the oil we do have and develop alternative sources of energy.

Inflation, the energy crisis, as well as the low rate of profitability of American business, have had an impact on the securities industry.

Just as the rush into the market during the '60s was a natural response to the prevailing economic climate, it is hardly surprising that the equity markets are relatively unattractive. Medium-term government bonds today yield approximately 10-1/2 percent. Quality municipals are even more attractive. Six-month savings certificates are available at commercial banks, and savings and loan institutions are yielding about 11 percent. Under these circumstances, both professional investment counselors and individual investors have questioned the incentive to invest in equities.

Ever-increasing proportions of individual savings are finding their way into pension funds and other institutions as well as real estate, ceramics, jewelry, etc. At the same time, however, these institutions themselves have been placing a larger share of their own new money in fixed income securities and in such equities as are eligible under ERISA.

Developments such as these have serious negative implications, particularly for new equity issues -- which have become virtually extinct as contrasted to the late '60s and early '70s. Today, it is essentially the higher-quality, well-capitalized companies that enjoy access to the equity markets. The problem is even more serious for companies seeking to come to market for the first time. And many companies cannot raise additional debt without expanding their equity base. Thus, they are caught in a growth-constricting vice. Their choices are either to restrain their growth or be acquired by larger companies. The shortage of equity capital, in the long run, inhibits technological advancement and dampens increases in productivity. It discourages the development of the Xeroxs and IBMs of tomorrow.

Although equities have not performed as well in recent years compared to the 1960s, and their relative importance as an investment vehicle has declined, the volume of trading has increased significantly. This has led to increased pressure to develop new and more efficient trading and back office facilities to accommodate not only current levels of trading activity, but also anticipated increases in volume in the future, and to be prepared for the time when investors become excited about equities again. We have reason to be impressed and pleased with the industry's ability to scale up to current volume levels -- double those of several years ago -- and to handle peak days of more than 80 million shares. But we cannot become complacent. We need to be prepared for another doubling of average daily volume with peaks of up to 150 million shares per day. In view of these developments and trends, the automation of exchange floors, back offices, clearing, routing and linkages is essential totally apart from a Congressionally-mandated national market system. Adapting the trading of securities through the use of technology and communications to meet the increasing level of trading, to assure more efficient and cost-effective executions and to foster competition in all aspects of the markets is the goal of the establishment of a National Market System for securities which the Congress, in enacting the Securities Acts Amendments of 1975, directed the Commission to facilitate.

Also essential, totally independent of a National Market System, is the adequacy and effectiveness of the regulatory and surveillance activities of the SROs. If the principle of self-regulation, which I strongly support, is to continue to be effective in a dynamically growing and changing marketplace, its adequacy must be the subject of continued attention and enhancement. In furtherance of this effort, the Commission has enhanced significantly its commitment of resources and attention to SRO oversight.

As you are aware, the 1975 Amendments neither defined the term "National Market System," nor mandated specified components of such a system. Congress recognized that the Nation's securities markets are "the finest in the world," and while it contemplated significant changes, it also wished to assure that the "delicate mechanisms" associated with the capital-raising process would not be harmed. Accordingly, Congress created a statutory scheme which allowed the Commission "maximum flexibility in working out the specific details" of what elements should comprise a National Market System consistent with Congressionally-determined goals and objectives.

The Commission shares the Congress' appreciation of the critical importance of a healthy and efficient securities market. We believe that the securities markets are at the heart of our economic system. They provide the indispensable mechanism which makes the capital-raising and allocative process work efficiently, fairly and with liquidity, and by which American industry obtains the resources necessary to provide jobs, create goods and services, and ultimately, define our standard of living. Accordingly, although some have complained that the Commission has moved too slowly in assuring the implementation of needed facilities and regulatory changes, we must weigh the benefits of rapid change against the risks to investors, the securities industry and the securities markets themselves, in the event the Commission's assumptions, in a particular instance, are wrong or because other events make those assumptions no longer valid. For example, some have estimated that the creation of a totally automated trading system might result in an annual savings of up to $100 million -- approximately one cent a share. Indeed, it may be that the actual dollar benefits of such a system would be even higher. However, we must also remain cognizant of the costs, not just in terms of systems design and computer hardware, but also in terms of the possible damage to the securities markets which may result -- and which may far exceed a penny a share.

It has been argued by some that implementation of a fully automated trading system would probably result in the elimination of exchange markets with physical trading floors and the replacement of that structure by an untested and untried system. Given the importance of the securities markets to the American economy, we cannot permit our desire for facilities innovation to result in the elimination of the desirable features of the current trading system without confidence that its successor will be superior and the transition orderly and in investor interests. The loss of investor trust and confidence and the resultant cost to the Nation's economy would be too high. If a transition to a fully automated trading system is to be developed, it should occur as a result of economic forces and acceptance by investors rather than by Commission mandate.

Development of a fully automated trading system would involve decisions which may have profound effects on the securities industry and the investing public as they alter the environment and the manner in which securities are traded. Accordingly, while the Commission believes it is important to move expeditiously in facilitating the implementation of those facilities which are fundamental elements of a National Market System or which may be accomplished without unnecessarily disrupting the current market structure with respect to other decisions which implicate more profound changes in the markets, the Commission perceives a special need to grasp clearly and as completely as possible the consequences of its decisions.

Because of the complexity of the issues involved in the creation of a National Market System and the interrelationships of the different aspects of the National Market System program, the Commission believes it is appropriate to continue to approach its task of facilitating the establishment of the system in an evolutionary manner. The Commission's role is not -- nor should it be -- that of system's analyst or designer of facilities. The Congress directed the Commission to "facilitate the establishment of a national market system," not to unilaterally create one.

The Congress expected that the securities industry would assume primary responsibility for the design and development of the technical components of the system. The Commission's role in this process has been, and will continue to be, to act as a catalyst, and when necessary, to take regulatory action to achieve a particular goal or eliminate unnecessary or inappropriate barriers to competition. However, while the Commission cannot be the builder, owner and financier of the National Market System, we do intend to assure that progress toward achievement of that system continues with all deliberate speed. If the industry fails to make acceptable progress, the Commission may well need to assume greater risk and take whatever action is necessary and appropriate to assure adequate movement toward achievement of the Congressionally-determined goals.

Significant progress has been made. A consolidated transaction reporting system is operational, making available to brokers, dealers and investors last sale information with respect to listed securities. As part of this system, the industry developed a high-speed data transmission line which, for the first time, enables vendors of market information to supply current information with respect to securities trading even when the traditional ticker network falls behind due to heavy volume -- a development particularly appreciated as volume has exploded.

A functioning consolidated quotation system, long considered a cornerstone of a National Market System, has also become operational, and quotation information for reported securities, while still in need of improvement, is now an integral part of the Nation's securities markets. In addition, two facilities designed to explore the efficacy of different types of computer and communications systems are currently in operation on a pilot or experimental basis. One of these, the Intermarket Trading System (or ITS), is designed primarily to link physically separate market centers and permit orders for the purchase and sale of multiply-traded securities to be routed between those centers for execution. The other system, the Cincinnati Stock Exchange National Securities Trading System, represents primarily an experiment in the use of a fully automated, electronic trading system. Both systems evidence considerable potential for the application of automation and computer and communication technology to overcome some of the problems associated with market fragmentation. The Commission has recently extended its approval of both systems for an additional three years to permit observation of the effects of these two systems on the markets and to better evaluate the possible role of those systems in the evolving National Market System.

Two other recent industry initiatives also deserve mention. At our hearings this summer on off-board trading restrictions, the National Association of Securities Dealers announced that it planned to spend approximately $10 million to enhance its existing NASDAQ electronic inter-dealer quotation system to permit that system to be used for order routing as well as for automatic execution at the option of the market maker. I commend this effort by the NASD as essential to the integration of the over-the-counter markets with the National Market System in response to the Congressional directives.

In addition, Merrill Lynch has begun to test, on a pilot basis, its Best Price Selector. This system permits orders to be routed on an individual basis to the best market based on on displayed quotations.

I believe that both of these developments are significant, not only because they offer promise of advancing the goals sought to be achieved in a National Market System, but also because they represent the type of positive industry initiative in response to market system developments which should be expected to occur and which evidences the industry's commitment to improving the markets to meet the needs of the future.

While we have come a long way, much more needs to be accomplished. First, both market professionals and self-regulatory organizations need to increase their efforts to ensure compliance with the Commission's quotation rule. As we indicated in our recent order approving extension of the ITS for an additional three years, we are concerned that members of the various market centers participating in the

ITS are not honoring their displayed quotations and that as a result, some users of the system perceive that quotation information from certain exchanges and specialists are unreliable. The Commission believes that accurate and reliable quotation information is essential to achieving best execution of customers' orders and assuring fair competition among market centers as contemplated by the 1975 Amendments. As a result, at our direction, the staff sent to each participant in ITS and to the NASD a letter expressing concern over current efforts by those self-regulatory organizations to enforce compliance with the quote rule, and requesting each of them to develop effective procedures to do so.

We have now received responses from the various self-regulatory organizations describing generally their current surveillance and enforcement program with respect to the quote rule, and in some cases promising enhanced operations in the future. We are encouraged by these responses. We remain committed to the basic policy underlying the quote rule and therefore expect that the exchanges and the NASD will assume an active and affirmative role in this area. Moreover, the ITS participants must take active steps to eliminate "trade throughs," whereby brokers or dealers in one of the linked markets ignores a better displayed quotation from another market. This type of activity is inconsistent with the concept of a National Market System and should be eliminated.

Second, although the Commission believes that increased use of data processing and computer technology is essential in meeting the objectives of a National Market System and that it is appropriate, as that system evolves, to encourage pilot or experimental programs designed to explore the efficacy of different types of systems, if particular systems are to be permanent features of the National Market System, they must continue to make improvements, changes and adaptations to meet the needs of persons trading in the various market centers and to accommodate Commission regulatory requirements. In this regard, while we recently extended our approval of the ITS and the CSE System for an additional three years, we noted various aspects of the two systems which require attention during the extension period.

With respect to the ITS, the Commission believes that in addition to achieving full compliance with the Commission's quotation rule in all participating market centers, the ITS participants should continue their efforts to enhance the system to further reduce response times in order to increase the efficiency and usefulness of the system. In addition, the ITS participants need to promptly take whatever steps are necessary to conclude discussions with the NASD with respect to implementing a computerized linkage between the ITS and over-the-counter market makers regulated by the NASD, and to arrive at a satisfactory basis for such a linkage between the ITS and the CSE System. Such linkages, in our view, are necessary to achieving the full integration of markets contemplated in a fully operational National Market System, and we urge all of the interested parties -- the ITS participants, the NASD and the CSE -- to move promptly to solve whatever technical and policy problems are associated with linking traditional exchange floors with both over-the-counter markets and exchanges (such as the CSE) which elect to utilize automated trading systems.

With respect to the CSE System, the Commission believes the CSE should take whatever steps are necessary to arrive at a satisfactory basis for a computerized linkage with the ITS. The Commission also intends to continue to monitor closely the operations of the CSE System and to analyze trading in the System and the market structure implications of use of the System by firms which transact business on a principal basis with their own retail customers. In this regard, Control Data Corporation, the owners of the hardware and software used to operate the CSE System, has already begun creating new software which will enable the System to generate reports which will simplify the Commission's task of analyzing data relating to the incidence and impact of such trading through the CSE

System. The Commission stands ready to take remedial action should such trading have adverse effects on the markets or investors.

I should point out, however, that issues relating to "internalization" are not limited to trading through the CSE System, but also arise in other contexts. The Commission believes it is important to ultimately address the significant market structure questions, both legal and policy, which result first from the ability of firms, in a variety of situations, to transact business on a principal basis with their own retail customers, or to otherwise combine principal and agency functions for a particular security, and, second, from the need to ensure that order flow in a particular market center is exposed to buying and selling interest represented in other market centers.

Another area where additional industry effort is needed is the development of neutral order routing facilities so that a broker can efficiently route orders for the purchase and sale of multiply-traded securities to any market center where that security is traded. The NYSE and the AMEX have developed an effective order routing mechanism -- the common message switch -- to route orders to those two markets, and have indicated their willingness to make that mechanism available on reasonable terms to other market centers. However, the NYSE and the AMEX have thus far not worked out interfaces between the common message switch and computer systems operated by other self-regulatory organizations which permit the automated execution of orders, and that, as a result, the Commission understands there has been little incentive on the part of those organizations to incur the costs associated with obtaining access to the switch. Because of our overriding concern that brokers be afforded an opportunity to easily route their customers' orders to the best available market, and in light of the NASD's recent commitment to a major systems enhancement of NASDAQ to provide more efficient, automated means for over-the-counter market makers to execute orders, we believe the NYSE and the AMEX must resolve their concerns with automated execution systems and proceed to implement linkages. I will be meeting with the parties in the near future to evaluate problems and determine the course of action to be followed.

Finally, we need, in the near term, to achieve inter-market price protection for public limit orders. We also need to explore means of more fully enhancing and preserving competition in the securities markets and for achieving the Congressional intent that those securities -- including securities currently traded exclusively in the over-the-counter market -- which possess characteristics which make them appropriate for auction-type trading, are included in the National Market System.

In this regard, we have proposed three rules which would, if adopted, establish nationwide price protection for all displayed public limit orders, eliminate off-board trading restrictions with respect to newly-listed securities and provide procedures for the designation of National Market System securities. In addition, each exchange and the NASD has indicated in writing to the Commission its commitment to the near-term achievement of price protection for displayed public limit orders, and the ITS participants have recently submitted a joint letter which gave an overview of how they intend to provide such limit order protection through the ITS.

In recent months, the Commission has received a great deal of useful comment on its various proposals through both oral hearings and the normal written comment process. That comment has focused the Commission's attention on the crucial issues which need to be resolved before those proposals can move forward. For example, with respect to price protection, we need to resolve whether such protection should be achieved through Commission regulatory action or through the voluntary efforts of the various self-regulatory organizations. Is the ITS a sufficient vehicle to achieve price protection between geographically separate markets? Assuming that Commission rulemaking in this area is appropriate, is it premature to adopt a rule at this time in light of the efforts of the ITS participants to develop a joint industry plan providing for inter-market limit order protection?

With respect to our off-board trading proposal, we need to conclude whether, in our judgment, adoption of the proposal, even though it involves only a small number of stocks, would permit unacceptable levels of internalization, and if so, what consequences that would have on the markets for those stocks. Does the proposal have experimental value, even if not statistically significant or extrapolatable, in permitting observation of a mixed exchange and over-the-counter trading environment in a setting which does not appear to threaten the general viability of exchange markets? In the absence of such a proposal, will the continued listing of stocks erode the competitive position of the over-the-counter markets? Do market linkage systems need to be in place before off-board principal restrictions are removed even for the small number of issues currently covered by our proposal? How should we balance the anti-competitive implications of remaining exchange off-board trading restrictions, such as NYSE Rule 390 and AMEX Rule 5, against the concerns expressed about fragmentation and internalization in over-the-counter markets? Enhancement of competition needs to be assessed in the context of carrying out our regulatory responsibilities under the Act. For example, the greater the number of competing dealers and markets in diverse locations, the more difficult it is to assure "economically efficient execution" or "opportunity for orders to be executed without the participation of a dealer." The economic advantages attributed to competition are not necessarily consistent with all other public policy goals of investor protection.

With respect to our qualified securities proposal, we need to conclude whether the proposed two-tier system provides a designation procedure which will assure that all securities which would benefit from trading in a National Market System are included while still maintaining the flexibility to consider the views of self-regulatory organizations, issuers and market makers as to whether that system -- as has been suggested by some commentators -- would be cumbersome, and in effect, create a "second-class citizenship" for some National Market System securities. What criteria should be used -- either in a two-tier approach, as we have proposed, or in a single set of standards? What is the appropriate role of issuers in the process, consistent with the Congressional intent underlying the 1975 Amendments? What should be the timing of inclusion of securities currently traded exclusively in the over-the-counter markets, and what effects will developments such as last sale reporting have on market makers for those securities? Should effective market linkage systems be in place before designations are made? And finally, should a pilot program precede full implementation of the Commission's qualified securities proposal?

These are all complex questions. The Commission and the staff are analyzing the many thoughtful comments received. We will move promptly to consider each of these proposals, and to resolve the various policy and timing issues raised which, in our judgment, will best achieve the objectives of a national market in a manner consistent our evolutionary approach to facilitating establishment of that system.

Commission regulatory action, however, is only part of the process by which a National Market System will evolve. Continuing industry initiative and innovation is necessary to assure continued progress and experience and to provide both the Commission and the industry with the data and confidence needed to evaluate and make judgments about the significance of developments, their constructive impact on securities markets and consistency with Congressional expectations for the National Market System.

Although we clearly have made substantial progress toward achieving some of the goals of a National Market System, much more remains to be done. At the recent oversight hearings conducted by the House of Representatives, considerable concern was expressed that the National Market System program was not moving fast enough. In order to fully achieve the goals Congress established, the momentum for positive change which has characterized recent industry efforts must continue.

* * *

Conclusion

Our capital markets are today the finest in the world. Nothing in the restructuring which those markets are currently undergoing is inconsistent with maintaining that pre-eminence -- indeed, the development of a National Market System will, in my judgment, contribute significantly to the continued strength of, and international confidence in, our markets and the private enterprise system they support. Similarly, nothing in that restructuring is inconsistent with a financially-sound securities industry which affords significant profit opportunity and reward for risk-taking. Our obligation -- both the industry's and the Commission's -- is to put aside the natural tendency to fear the unknown and to get on with the task of building a future for our securities markets which will ensure that the strength and vitality which make them the envy of the world will endure.