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"THE FUTURE IS NOW"

Address by

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Coach George Allen of the Washington Redskins football team reportedly lives by a motto which in my opinion must be embraced by all segments of the securities industry intending to continue in this business. His motto, "The Future is Now," is especially appropriate for the Boston Stock Exchange and other regional exchanges which have pioneered many of the innovations in our securities markets. These modifications generally have been the result of a struggle to fulfill a meaningful function and thus survive during a period of fundamental economic and technological change. Today, as never before since the Boston Stock Exchange was organized in 1834 to provide trading markets for securities of local banks and railroads, there is a need for regional exchanges to be innovative and competitive.

This is not a new posture for an exchange which in 1844 was the first regional exchange to publicize its transactions and in 1885 was the first regional exchange to change from a "call" system to a "continuous method" of trading. In order to appreciate fully the importance of the ability to adjust to new conditions as a competitive central market system is formed, I believe it is worthwhile to trace the evolution of regional exchanges.

Before the development of nationwide communication facilities, the floors of the regional exchanges served as a meeting place for face-to-face bargaining for securities. In their early history, such exchanges participated in many first-time distributions as well as after market trading of local bank and industrial securities. However, as local businesses consolidated into national industries, regional exchanges suffered a major loss because many issues which had been traded on these exchanges disappeared. In addition, successful local companies with a need for national financing frequently sought listing on one of the New York exchanges. Moreover, as communications improved, many regional brokerage firms merged with New York firms or obtained seats on the New York exchanges while some New York firms joined regional exchanges, thus becoming dual members.

The enactment of the Securities Exchange Act in 1934 precipitated another significant loss to regional exchanges. The Act established minimum reporting standards for companies listed on national exchanges that were more stringent than had previously existed. When required to meet the higher standards, some companies moved from regional exchanges to the New York exchanges which had greater prestige and public appeal. Others chose not to meet the new standards and delisted, thus becoming over-the-counter traded companies.

To recapture some of the local business going to the New York exchanges, regional exchanges increased their reliance on unlisted trading of non-local securities. While the original draft of the Securities Exchange Act did not provide for unlisted trading, as enacted, Section 12(f) authorized such trading for a limited time period during which the Commission was directed to study trading in unlisted securities and report its recommendations to Congress.

In its 1936 report on Trading in Unlisted Securities Upon Exchanges, the Commission indicated that about two-thirds of the shares available for trading on regional exchanges were not listed but had been granted unlisted trading privileges. It also stated that more than half of the trading activity on such exchanges was in these unlisted issues and concluded that if unlisted trading were not continued, concentration of the control over the allocation of the nation's capital in New York City would be accelerated. The report also expressed concern that in such an event financing of local businesses would suffer.

Following this report, Congress amended Section 12(f) of the Securities Exchange Act in what was described as "an endeavor to create a fair field of competition among exchanges and between exchanges as a group and the over-the-counter markets and to allow each type of market to develop in accordance with its natural genius and consistently with the public interest." The amendment permitted unlisted trading privileges to continue on an exchange to which a security had been admitted prior to March 1934, permitted the Commission to extend unlisted trading privileges under certain limited circumstances for unlisted securities, and most important, authorized the Commission to permit the extension of unlisted trading privileges to any security which was and continued to be registered on another national securities exchange.

The statute provided, however, that applications for such trading privileges were not to be approved by the Commission unless it could be demonstrated that there was sufficiently widespread distribution and public trading activity in the vicinity of the applicant exchange that the unlisted trading privilege would be necessary or appropriate in the public interest or for the protection of investors.

One of the early Commission cases under this provision involved the Boston Stock Exchange in 1937.[1/] In this proceeding, the Commission indicated that a mechanical pricing mechanism for trading round lots on regional exchanges geared to the primary exchange market was not appropriate because orders traded in such a manner would not be part of an independent regional auction pricing process and would also be removed from the auction process in which the price of securities was established in the primary market. On the other hand, the Commission took the position that a regional odd lot trading mechanism geared to the primary exchange market was appropriate because odd lots sent to the primary market did not enter the auction process but were executed in this same mechanical manner.

This decision, of course, restricted the number of securities regional exchanges could trade. It was only one year later in 1938 that the Commission reconciled this decision with needs of regional exchanges by approving a Boston Stock Exchange proposal for unlisted trading privileges in round lots in securities for which the exchange

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1/ Applications by the Boston Stock Exchange for Unlisted Trading Privileges, 2 S.E.C. 513 (1937).

would establish a regional market, but which nonetheless allowed investors to insist on executions based on the primary market price.[2/] It appears clear that the intent and effect of this decision was to maintain the smaller exchanges by giving them an opportunity to expand their round lot volume and thus opened the door to multiple trading as it exists today. Implicit in this decision, and others that followed, was the Commission's recognition that in view of nationwide dissemination of primary market prices and investors' demand for primary market price protection, regional exchanges would not develop into fully independent competing markets but would rely on the primary markets to a great extent.

In the so-called "Multiple Trading Case" three years later, the Commission clearly indicated that as far as multiple trading was concerned the maintenance of regional exchanges was in the public interest.[3/] In this landmark decision, the Commission ordered the NYSE to amend a rule which provided that NYSE members dealing in NYSE listed

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2/ *Applications by the Boston Stock Exchange for Unlisted Trading Privileges*, 3 S.E.C. 693 (1938).

3/ *The Rules of The New York Stock Exchange*, 10 S.E.C. 270 (1941) securities on other exchanges would be subject to disciplinary proceedings, including expulsion. The Commission determined that the application of this rule would force many NYSE members to give up regional specialist posts, curtail multiple trading and thus cause irreparable damage to regional exchanges. In its decision, the Commission stated:

> * * * Furthermore, deleterious economic consequences to trade and industry, particularly to growing industries located in areas surrounding the regional exchanges, can be expected to ensue. For many years the regional exchanges and the market facilities which they maintain have been important factors in the financial lives of their communities . . . .
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> In view of the foregoing discussion, the harm which investors would suffer from enforcement of the rule needs little elaboration. * * * If the regional markets in dually traded issues are destroyed or materially decreased, the public investor who wishes to buy or sell such securities will have to trade on the NYSE and pay the higher costs attending such transactions. Even if the issues affected by the rule continue to be traded on the regional exchanges, the customer can expect slower deliveries and poorer service in many cases. The debilitation of regional exchange services in dually traded issues will also permeate their trading services in local issues as well. The investor may therefore be faced with the alternative of trading only in the centralized market located in New York or in the over-the-counter market. 4/

4/ *Id.*, at 283-284.

Since the Multiple Trading Case, the character of trading on regional exchanges has gradually shifted. The number and volume of securities transactions in issues traded solely on regional exchanges have declined drastically and such exchanges have become increasingly dependent on multiple trading. Today, regional exchanges provide a means for sole members to trade in securities listed on other exchanges and yet retain a good portion of the commission; they make it possible for dual members lacking executing and clearing facilities in New York to save charges for those functions by executing transactions on regional exchanges; and they serve as a mechanism for access to the primary market and a recapture of commission charges for large volume or large block public customers. Furthermore, they may assist customers to obtain better execution by providing depth through the "split order" technique in which a regional specialist sends part of the order to the primary exchange and executes the remaining part at the same price as the last round lot portion executed on the primary exchange. Dual members having execution and clearing facilities in New York also find it to their economic advantage in some instances to execute transactions on regional exchanges.

It is important to note that the basis of most multiple trading transactions on regional exchanges is the desire to escape the fixed commission charges of the New York stock exchanges. This puts in bold perspective the possible impact of the Commission's decision to require competitive commission rates on May 1, 1975. In plain language, competitive rates may undermine a major part of the foundation presently supporting regional exchanges.

Does this mean that regional exchanges will be unable to survive in this new environment? The answer depends on the ability of the Boston Stock Exchange and other regional exchanges to adapt to a changed environment as you have done during critical periods in the past. With such adjustments, I expect the Boston Stock Exchange to be a healthy and viable regional component of the central market system and to fulfill a role similar to that contemplated for regional exchanges by the Commission and the Congress in the 1930's.

In the central market system, the system itself, as opposed to the floor of any exchange, becomes the market. All components of the securities industry will participate in the new market to the extent they are competitive in their services and quotations. The first step in this process should be in operation by February of 1975, at which time trades in General Motors or any other qualified security effected on the Boston Stock Exchange, any other exchange, or in the third market will be nationally advertised through the composite transaction tape.

With the advent of a composite quotation system, the Boston Stock Exchange market maker will be able to display his quotations in multiple traded securities. To the extent that his quotes are competitive with those from other markets, he will have an opportunity to execute more trades. If his quote is the best, brokers, regardless of their market location, will have an obligation under best execution principles to seek him out instead of automatically sending all orders to one specific stock exchange. If his quote is as good as those of his competitors, he may see orders that now are not shown to him. Today he has no exposure to many orders either because of difficulties in communicating to a wide audience of professionals or because some, at least, do not obtain the quotes of regional specialists. Clearly, with a composite quotation system he will have a better chance to compete, and thus, the Boston specialist will have an opportunity to break into the order flow in a way never before possible.

An additional factor that should be considered is that the nationwide exposure of Boston Stock Exchange transactions and quotes could well attract broker-dealers who have been unable to become specialists on primary exchanges. Furthermore, some broker-dealers with well-known upstairs trading capability may be attracted to specializing on the Boston and other regional exchanges. No less important is the potential for institutions to make their capital available to regional specialists. The Commission has indicated its belief that this could be a highly desirable development and I understand that some insurance companies are considering very seriously making capital available for specializing on regional exchanges.

There may also be possibilities for competition in clearing, settlement, and depository services when these services are required to be offered on an interface basis. This might be a form of professional unbundling where brokers and dealers may shop not only for the best price for securities but also the best price for services related to the execution of transactions and safekeeping of securities. On the other hand, Boston Stock Exchange specialists will be competing with well capitalized specialists on the American and New York

Stock Exchanges and other well capitalized market makers, and trades that now come to the Boston Stock Exchange because of regional pride may be broken by competitive bids or offers from market makers on the New York exchanges or in other regions or in the third market.

Thus, a central market system may well be the means by which the Boston Stock Exchange prospers and grows significantly in volume or the means by which it withers. Other factors, not alluded to here, may influence the outcome; but the principal factor determining the direction in which the Boston Stock Exchange goes will be its commitment to be competitive.

In my opinion the composite quote system is essential to the survival of regional exchanges in an era of competitive commission rates. Now that the composite tape plan has been declared effective and we can look forward to that plan being operational by February of 1975, the Commission and its staff will focus our attention on implementing the composite quote system as soon as reasonably possible.

I believe the Commission should decide within the next two or three weeks whether to republish Rule 17a-14 in the form originally proposed, which as you will recall requires exchanges and broker-dealers simply to make quotes in listed securities available to vendors, or whether to follow the course adopted in the composite tape plan, which permitted self-regulatory organizations to come forward with a plan of their own for the dissemination of last sale transactions. As you are aware, the course followed by the Commission in the composite tape rule finally produced what we hope is the beginning of a workable plan for the reporting of all eligible listed securities. Nevertheless, the process seemed to drag on interminably. The Commission is now reflecting on this experience to determine the most practical and efficient way to have a composite quote system operational in the near future and not several years from now, as some have suggested.

In a recent hearing before the Senate Subcommittee on Securities, the New York Stock Exchange testified that its viability will be threatened during the interim period between the beginning of competitive rates and the implementation of the composite quote system and other components of the central market. Whether that is true is a matter of debate, but I believe there is no doubt that the viability of regional exchanges and present third market firms will be in jeopardy during that period.

It would appear, therefore, that all participants would be anxious to bring about a composite quote system as soon as possible, perhaps even concurrent with the unfixing of commission rates. If present incentives are not sufficient, it may be helpful to point out that there is already in existence a composite quote system in the form of NASDAQ with terminals in most brokerage offices presently displaying quotes for over one hundred exchange listed securities. This system could display quotes for all exchange listed securities just as existing tape systems will be used to report last sale transactions for listed securities on a composite basis. There are also other electronic interrogation systems in operation which could be utilized for this purpose. Furthermore, the Commission, if necessary, could take action to assure that brokers are seeking to obtain best execution in the marketplace.

It should be noted also that, in conjunction with the composite quote system, the Commission intends to require all regional exchanges to come forward with a plan to regulate specialists. Today, as is the case with third market makers, regional specialists and floor traders are not regulated to the same degree as specialists or floor traders on primary exchanges are regulated. Although the Commission has received criticism for not equalizing these differences at this time, the Commission believes strongly that equal regulation of unequals is not necessary or appropriate. In addition, experience with the central market system may demonstrate that competition will supplant the need for some regulatory requirements on market makers. The markets on regional exchanges are tied to the primary exchange tape; thus, it becomes extremely difficult if not impossible to "manipulate" a regional exchange market in a multiple traded issue. Also, regional exchange floor traders would expose themselves to great risk if they were to make decisions based on the trading activity on the floor of the regional exchange, without knowing the activity on the primary exchange floor.

With the implementation of a composite quote system, this position will need to be re-analyzed. For example, a Boston specialist may make such competitive markets in a security that the Boston Stock Exchange will become the primary market for that security. Moreover, with all market makers having access to the flow of orders in particular securities, with artificial compartmentalization of the markets eliminated, and with economic access by regional specialists and third market makers to the primary markets, it will be important that market makers operate under appropriate minimum standards. The Commission stated in its March 1973 Policy Statement that all market makers having access to the composite quote system should bear the responsibility to make fair and orderly markets. The specifics of that standard have yet to be determined. The Boston Stock Exchange staff, its specialists and other concerned members should begin to give some thought to the regulatory standards which should be applied.

I have confidence that the same tenacity and desire to survive that the Boston Stock Exchange has exhibited in the past will lead you in self-interest and the public interest to do all in your power to bring about the composite quote system as quickly as possible and that this exchange will not only continue to exist, but will become a strong participant in the central market system. If you do not rise to this challenge and opportunity, your chances for survival are not very good and the securities markets of this nation and all who use them will be poorer as a result.

Indeed, your future is now.