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A GLANCE AT THE PAST, A PROBE OF THE FUTURE

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A GLANCE AT THE PAST, A PROBE OF THE FUTURE

by A. A. Sommer, Jr.*

In a couple of weeks, my time as a Commissioner of the Securities and Exchange Commission will have ended, just short of two years and eight months of service. Obviously, an occasion like this is a bright invitation to look back on a time that in retrospect, at least, is bathed in refulgent light and clarity, and behold the wonders that have happened since the day I walked onto the Washington scene. Similarly it is an invitation to peer into the future which is far less illuminated, much more obscure, with outlines that are deceptive and dark. I would propose to do a little bit of each today = look lovingly back at the past, hesitatingly into the future.

When I took office as Commissioner (incidentally the same day that that distinguished Chicagoan, Ray Garrett, Jr., became Chairman of the Commission), the Dow Jones average stood at 908 and was on the way down; volume on the New York Stock Exchange was running about twelve million shares a day.

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While certainly all was not totally well with the securities industry, none of us then foresaw that the Dow Jones would sink to 577 and the NYSE volume would droop to the point where it was barely in eight figures - in fact, on some days it went below ten million shares. Happily on the day that Ray and I took our oaths that dark, menacing future lay obscured from us. At that time, commissions were still fixed on all transactions over $300,000, although there was then some apprehension as to how long the fixed commission system could endure in the world that was emerging. New York Stock Exchange seats were selling at about $100,000 and the CBOE had enjoyed four months of existence as a "pilot" project. The industry was toiling away to respond to the demands of Rule 17a-15 that each self-regulatory agency submit a plan for a consolidated tape. There existed on August 6, 1973, some hope that progress might be made towards either the amalgamation or the interfacing of the various clearing and settlement systems; DTC was steadily expanding its activity; there was much talk of the certificateless society. John Whitehead was urging the SEC to be the "friend" of the industry much as the banking regulatory agencies were of the banking industry, and all about us there were suggestions that perhaps it would be well if SEC conducted its activities, if not secretly, at least outside of the spotlight and more in the shadows. Each exchange carefully guarded the quotations of its specialists and distributed them over a limited network. Congress continued to ponder the consequences of the studies which both the House and the Senate Subcommittees had conducted and was pressing toward adoption of legislation including a whole host of reforms. Controversy raged over a number of issues, including fixed commissions, the dangers posed by the proposed legislation to the exchange system of trading securities and the principle of self-regulation, the meaning of the so-called "central market" which was then a somewhat visionary concept, and on and on.

How much has changed? The Dow Jones is once more flirting with the thousand mark. Volume has risen on the New York Stock Exchange as high as 44 million shares and has consistently been running at a level that assures a high measure of profitability to firms dependent upon commission business. Notwithstanding all of the assaults, verbal and otherwise, upon it, the New York Stock Exchange continues to be the preeminent market in this Country, in the world, for that matter, and enjoys 85% and more of the volume done in securities listed on that exchange. CBOE has been a phenomenal success, a success so great that leaders of the industry, as well as regulators, have begun to express grave concern over the possibility that the balloon may expand too much and eventually burst, with embarrassment to everyone concerned. The price of a seat on the CBOE is now about $94,000, about the same as a seat on the New York Stock Exchange - a phenomenon that no one could have foreseen 2-1/2 years ago. The Securities Acts Amendments of 1975 have been on the books now for upwards of nine months and self-regulatory agencies continue to thrive, the world has not crumbled and many of the characteristics that the securities markets had in the past are unchanged. A consolidated tape is functioning and in my estimation is functioning well, notwithstanding some transitional problems we read about because of the publication of composite figures rather than the New York Stock Exchange figures. Quotations of the various markets have become available to anyone willing to pay a reasonable price for them and it is expected that by this summer several vendors will be offering composite quotation services to anyone willing to buy them. Rule 394, at least insofar as it pertains to agency transactions, has been considerably trimmed and a good deal of its anticompetitive force taken out of it. People are beginning to think seriously about how to develop a composite limit order book that will place customers of every exchange and every other market on an equal footing with regard to limit orders. One by one, the competitive restraints which provided advantages to one market as against another are being toppled and all of them are in serious jeopardy. Unfixed commissions across the board at the retail level have been a fact of life now for approaching a year and while the transitional problems have been difficult for many, nontheless I think it is safe to say that they are a permanent part of the landscape; it is impossible to imagine a force other than total catastrophe in the industry which would make the SEC or Congress seriously consider their reestablishment. Of course, many of the impacts of the elimination of fixed commissions are probably being screened by the extraordinarily high volume and high prosperity of the securities industry; still, even had this volume and prosperity not occurred, there was not reason to think that the consequences of unfixing commissions were going to be so catastrophic as to justify a new intervention in the pricing mechanism for brokerage services by any governmental agency. And after the collapse of an earlier effort to achieve progress in unifying the clearing and settlement systems of the country, the merger of Stock Clearing Corporation, American Stock Exchange Clearing Corporation and National Clearing Corporation is close to reality and holds the promise of great benefits in the future. And finally, the banking regulators, the "friends" of the industry they regulated, are under intense fire for that very attitude and for other reasons and suggestions are being made in Congress that perhaps they have not been tough enough with those with respect to whom they had regulatory responsibility.

Inevitably, the question arises whether the industry as it exists today, the markets as they are now, are better than they were 2-1/2 years ago and obviously, any answer I give to this is in some measure going to be defensive. I think that unquestionably the securities industry stands on the threshold of even greater achievements than it has known in the past. Unfortunately, it will always be subject to periods of riches and periods of starvation. Our studies at the Commission indicated that virtually no other industry in the country is as afflicted with cyclical change as the securities industry where the fluctations in the brokerage end average about 25% per year. This situation, of course, is aggravated by the fact that more and more of the costs of the securities industry have become fixed as distinguished from variable, with the result that firms find it difficult to adapt to large drops in volume as swiftly as they did in the past. However, I think securities firms are more aware of their problems and the dangers of the cyclical nature of their business and have begun to take measures to reduce the hardship of that. For one thing, many of the houses have broadened their product line, thus making it possible for other activities, such as commodity speculation, options, and dealings in other kinds of securities and property to support the firm during periods when activity on the exchanges is lean. Furthermore, fixed though costs may be 'in higher proportions, nonetheless, the securities industry has thinned down its overhead, with the result that in good times, unless it lets itself become fat again, there is the opportunity to make tremendous amounts of money.

Notwithstanding the hardships which negotiated commissions have inflicted upon some firms, particularly research boutiques, the elimination of the fixed commissions has caused the industry to move in the direction of a more efficient and a more economically justifiable system of fixing charges. Granted that institutions pay extraordinarily low commissions on small transactions - but who is to argue that transactions requiring no particular skills, transactions that can and should be done quite mechanically and without the intervention of human judgment or skills, should not be priced at very low levels?

There continues to be the problem of how the good research capacity of Wall Street can be compensated and preserved during this transitional period. It appears that the problems relating to "paying up" are of two kinds, at least on a broadly considered basis. First, in some cases brokerage commissions are being paid for execution services and for other "services" which are well beyond the pale of what might be regarded as research. At the Commission, we find it very difficult to think that subscriptions to Playboy magazine are really research. On the other hand, we find a considerable reluctance on the part of many institutions to "pay up" for perfectly legitimate and valuable research services. If I may take a shot at my brethren at the bar whose ranks I will rejoin in a couple of weeks, I think that attorneys in the securities industry are taking far too conservative a posture in advising their institutional clients against "paying up". I don't think, and the Commission has never contended, that it is incumbent upon an institutional investor to secure the lowest price for an execution. It seems to me that, in a situation where dealings are at arms-length, there is no conflict of interest and there is no special relationship (e.g., doing business with a relative) other than a straight business one, the payment of a commission that is intended to secure not only good execution but other research services as well should not and will not be subject to nitpicking criticism or vexatious litigation. I think it is important to recognize that the litigation which is the reason for concern by institutional investors and their counsel has almost invariably been about situations involving a conflict of interest, some form of management self-dealing or self-aggrandizement or self-benefit, or some relationship between the manager and those he deals with that produces benefits to the manager that are inappropriate and inconsistent with its obligations to the beneficiaries of the trust or the shareholders of the investment company or others who are supposed to be served by management.

If one were writing on a completely clean slate, I think almost everyone would agree that the best course would be to have research compensated on a hard dollar basis and execution services purchased of course in the same manner. But we do not write on a clean slate. Instead, we write on a slate that is scribbled with various fairly fixed financial relationships, such as fiduciary fees, management fees for investment companies, trustees' fees and the like, which are not readily adjusted to provide dollars to purchase research services that were previously available as a part of the package sold for fixed commissions. I would hope that the "paying up" problem is a transitional one and that eventually the practice will wither, not because of any edict or regulatory reform, but simply because in time the necessary adjustments will be made which will permit the purchase of research services for hard dollars. Until that time comes, however, I think we must recognize the will of Congress expressed in Section 28(e) of the Securities Exchange Act of 1934 and provide guidance to institutional managers and their brokers concerning what is permissible and what is not by way of "paying up", and this the Commission hopes to do in the very near future.

During the next two or three years - perhaps, for a decade or more - the principal discussions in the securities industry are going to focus around the development of a national market system. As I remarked a moment ago, some of the components of that system are already in place or are moving toward being in place: the consolidated tape is operational and the composite quotation system is close to being operational. Attention is now centered upon the development of a composite limit order book (carrying now the inelegant acronyn, CLOB). The Commission has asked for comment from interested parties by May 1, 1976, with regard to what should be the constituent elements of a composite limit order book system, what rules and regulations should surround such an entity, what alternatives there are to the prevailing notions that such a system must incorporate a number of sophisticated electronic mechanisms. I am pleased to learn that some members of the securities industry are seriously examining whether, in order to accomplish the benefits of a composite limit order book, it is necessary to expend significant amounts of money to develop the kind of electronic mechanism that has been discussed. The idea of joint accounts among specialists on various exchanges or a means of permitting the specialist in the principal market for the stock to act in effect as the book for all markets and other alternatives deserve serious study.

I think it is clear that the Commission has committed itsélf to a prompt development of some mechanism, electronic or otherwise, whereby all limit orders in a security will be exposed to all markets for that security. While this objective is clear, and while it is possible to pose the questions and answer them with regard to characteristics of an acceptable system - who shall have the right to put orders in the system, who shall have the right to exeoute against orders in the system, who should be permitted to see the book and so on, the problem of how an electronic mechanism, if such is necessary, is to be brought into existence is a considerably more complex one. The Commission has considerable powers under the Securities Exchange Act of 1934 as amended last year but it seems to me that it may lack the most critical power of all. The Commission's release in February which solicited comments about the composite limit order book, spoke of the Commission considering all submissions of the plans for the implementation of such book and then selecting from among them the best one. The question endures in my mind, when the Commission has decided which is the best system, what then? What incentives will the Commission be able to afford the designer of the best system to assure that it will be economically feasible for it to incur the very substantial expense necessary for the development and implementation of such a system? Who will pay for the use of this service and who will determine how much? Who will be able to enter into a binding contract with the designer of the system and guarantee the quid pro quo that will be necessary for anyone sensibly to undertake such a project?

When the NASDAQ system was developed, there was a party on the other side of Bunker Ramo fully capable of entering into a binding contract, namely, the NASD. Ask yourselves how the NASDAQ could have been brought into existence had there been no entity with the powers and contracting ability of the National Association of Securities Dealers.

I suspect as the time grows closer for the Commission to select among the plans that will have been proposed, the absence of this sort of power in either the Commission or some other body will become increasingly apparent and increasingly important. It may well be that an imaginative coupling and shuffling of the Commission's present powers may be sufficient to bring into existence a composite limit book system. At the moment, I must confess to doubt concerning this and I would suggest that one of the recommendations of the National Market Advisory Board may be that Congress provide by law the power, either to the Commission or to some new board concerend with the governance of securities markets, to enter into a binding contract and the ability to assure that the mechanism will be used in a fashion that will provide the necessary return to a private vendor.

Once the vital decisions are made with regard to the composite book, the industry will confront the ultimate question of whether it wishes on the near term to use to the fullest the technology available to develop a system which will have the characteristics of the so-called "locked in" trade - a totally automatic system, except for a limited exercise of judgment and discretion with regard to large orders, from the moment of order entry to the last moment of ownership transfer and settlement. At this moment, I doubt whether anyone has any concise notion of what the cost of this would be and there is very little consensus with regard to the manner in which such could be accomplished.

There have been a number of expositions - verbal, graphic, popular, scientific, plain, obscure 0 as to how all this can be done. It is simply not enough that ideas about such matters be abroad in the marketplace. At some point, either a consensus must be developed among those with heavy stakes in such a development - and I do not see that in the near future - or someone must be empowered to bring the result about. Whoever has that power will need to have the power to make the necessary contracts, assure a reasonable opportunity for return of and profit on investment, and supervise the operation of the mechanism to assure that it serves the purposes for which it is designed. Whether that agency will be the Securities and Exchange Commission, or some other governmental agency, or a national market board of the sort contemplated by Representative William Stuckey at the time the Securities Act Amendments were under consideration, it is impossible to tell. I would suspect that in the ultimate, the National Market Advisory Board would opt for the latter course, simply because there is usually a predisposition to minimize the involvement of government in the organization and operation of markets.

The "black box" leads into some of the most troublesome questions which will have to be confronted. It opens up the question of whether exchange floors will have any raison d'etre when there exists such an electronic marketplace. It raises the most fundamental questions concerning the role of specialists and other market makers. It poses dramatically the question whether there should even be separate entities called "exchanges". It raises the question about the value, if any, which would remain in having securities listed on a prestigious exchange.

There is nothing in the legislation enacted by Congress that requires the full electronic implementation of the central market system as it has been outlined by the Commission and contemplated by many, such as Morris Mendelson. There is no mandate that mechanisms for automatic execution be developed quickly. I would suggest that when solutions to the composite limit order book have been developed, whether they involve new electronic mechanisms or not, the pressure towards full automation of the securities markets will abate and from then on progress will be gradual, with the Commission continuing its role of assuring that no anticompetitive forces stall or hinder or delay developments which may stem from industry and individual self-interest. When the Commission and the self-regulatory organizations have eliminated all the anticompetitive restraints which are inconsistent with the purposes of the

Act, I would suspect that then natural forces rather than regulatory forces will finally become dominant and will determine the speed with which and the direction in which the national market system in its fullness will develop.

There are vast amounts of technological know-how in our society which economic considerations simply do not permit to be utilized at this time. Theoretically, we could have roads imbedded with guidance mechanisms that would permit automobiles to be automatically driven. We are denied these luxuries, not because the technology is unavailable, but simply because the cost is prohibitive in terms of the total priority system of our society. Similarly, in the securities industry, it is not in my estimation sufficient to say that the technology for the fully automated execution system is available. The decision to utilize that technology will have to be based upon costs and upon priorities, and it may well be that in time the consensus will be that further application of regulatory and other forces to bring about the fullness of technological developments is not justified on a short run basis, but rather, such changes will have to be achieved in a gradual, step-by-step, economically defensible way.

I am therefore expressing some pessimism as to whether the magnificent toys that we have been talking about for several years will happen in the next half decade or full decade, for that matter. It may well be that the market mechanisms as we know them today - exchange floors, some utilization of technological means, expansion of automatic execution capabilities for small orders - will continue for a long time. Competition among marketplaces will continue to impel exchanges and other market makers to find means of more expeditiously and economically serving those who are potential users of the exchanges and the market makers. Thus, little by little, bites of the pie will be taken by different participants in the market as they seek in the classical American fashion to achieve advantage over their competitors. It strikes me as unlikely that the fullness of the electronic market will be achieved in large strides or in one vast exercise of Commission authority.

But on the other hand, I think we will see in our lifetimes profound changes in the manner in which securities business is done. There is no doubt that there is substantial opportunity ahead for reducing the costs of execution; some have suggested that perhaps those costs could, given the appropriate electronic means, be reduced to a quarter or a sixth of what they are now. If that were done, would it result in the presence of greater numbers of investors in the securities markets? It seems to me this is a question that might well be addressed by research organizations: to what extent are transaction costs a deterrent at the present time to market activity? It may well be that the answer to that question could be of great importance to the securities industry, and to the Congress and the Securities and Exchange Commission, as all of them ponder the way to assure active and healthy securities markets in this country.

In another area, I expect that much greater efforts are going to be made to provide easy, efficient, and enticing ways for individuals to participate in securities markets. At one time Professor James Lorie, probably one of the most outstanding experts on securities markets in the world, suggested that consideration be given to the possibility that means be provided whereby individuals could "buy a share of the market" - that is, through a single payment of money they could buy into a vast mutual fund, if you will, consisting of shares of every security listed on the New York Stock Exchange, or another exchange, or on all exchanges, or perhaps on all exchanges and NASDAQ. This, of course, would be the ultimate in diversification and market indexation. We are told that this idea has no marketing sex appeal. But I would suggest that other means of making it easy for investors to invest, and more economical than it is now, will be developed by the securities industry. If for no other reason, the prod of potential competition from the banking industry will bring this about. At the present time, it is too cumbersome for people to open brokerage accounts; it is an unfamiliar and strange experience and many people shy away from it for those very reasons. The securities industry should rapidly develop a simplified means of opening accounts and investing in securities. To many people the stock market is a mystery. New marketing mechanisms must be developed to remove that mystery and bring a new category of investors to the equity markets. Some progress has been made in this direction by a number of large securities firms, efforts that appear to have directly followed from the elimination of fixed commissions. From the standpoint of capital formation, I can think of no more urgent project for the securities industry. All studies indicate that the number of people who make a substantial number of transactions in the securities markets each year, is very, very small; the notion abroad that 25 or 30 million people are active participants in the securities markets is totally unfounded. Means must be found to simplify the process, make it less expensive, make it more appealing. This should not be done by representing that untold riches await him who is willing to speculate in the market. Rather, it must be done on the basis that historically, investment in equity securities in this country has been a means for substantial long-term capital appreciation.

Foremost among the concerns of the securities industry in recent years have been the encroachments of the banking industry into domains that have historically been the exclusive preserve of the securities industry. I would suggest that this danger in recent months has abated considerably. As questions have mounted concerning the competence with which banks have conducted their traditional businesses, it seems to me that the Congress is going to be much more difficult to persuade that banks should be permitted to expand the scope of their activities. Unquestionably, there is an essential role in the American economy for an independent securities industry. I would regard it as a major defeat for our society if the securities industry became a mere appendage of the banking industry. I think this would stifle the imagination which has characterized the industry, and would result in a totally unwarranted and even dangerous concentration of economic power and would over the long run adversely affect the capital formation and capital allocation process of the country. But it is not enough in my estimation for the securities industry to point to the evils which might accrue from such a development. Rather, I would hope that the emphasis will be placed upon affirmative considerations, such as the ability of the securities industry to adapt to change, its ability to accept the full measure of competition, its ability to develop attractive incentives for those who are now strangers to the securities markets to become active participants. I have no doubt that the capacity to make these affirmative responses to the challenges of the times rests in abundance in this industry.