

Market Transparency

An Address by

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I. Introduction

I would like to thank the Financial Times, and Barbara Higgison in particular, for their gracious invitation to address you today on the topic of market transparency. Before beginning, however, I must note that, as a matter of policy, the Securities and Exchange Commission ("SEC" or "Commission") disclaims responsibility for any private statement by any of its employees. Accordingly, my remarks today represent my own views and do not necessarily reflect the views of the Commission or my colleagues on the staff of the Commission.

The question of how much transparency should characterize the markets for trading equity securities is only one aspect, albeit an important aspect, of market regulation. In general, securities regulation serves at least two purposes. First, such regulation protects investors from fraud and manipulation. Second, securities regulation is designed to ensure that, so far as practicable in a market-driven economy, securities markets are fair, orderly, and efficient. While there may be disagreement about how to implement these two purposes, there is general agreement about the purposes themselves.

Although it may be argued that in some respects the goals of investor protection and efficient markets conflict, in large part these goals are not only compatible, but reinforce one another. Effective investor protection promotes the investor confidence necessary to ensure public participation in the securities

markets. In turn, broad public participation in the markets helps promote liquid markets so that scarce capital resources are efficiently allocated through the price discovery process. Further, efficient markets help protect investors from fraud and manipulation.

In this connection, competition between and among markets facilitates both investor protection and efficient markets. When markets compete, they have the greatest incentive to create new products, design new trading procedures, ensure fair treatment of investors, and generally provide investors the most efficient array of services. Moreover, globalization of markets should increase competition in delivering products and services and, thus, contribute to fairer and more efficient markets. Such global competition also provides an opportunity for the free market to evaluate alternative trading procedures and methodologies.

At the same time, however, we need to ensure that market competition is consistent with the goals of protecting investors and maintaining fair, orderly, and efficient markets. We need to work together to avoid the two potentially adverse consequences of such competition.

First, there always is the possibility of markets and regulators competing in a race to the proverbial bottom. Such a competition in laxity ultimately will harm investors and undermine the efficiency and integrity of all markets. Second, even if we can collectively avoid competition in laxity, each

market may seek to regulate its own markets from an exclusively national perspective. The result of such policies could be a regulatory Tower of Babel, resulting in a net reduction in marketplace efficiency.

If we are to avoid these twin concerns of regulatory laxity and regulatory overkill, we will need to work together where possible to achieve some consensus on how to approach key regulatory issues. Even when consensus is not possible, we still will need to work together to minimize the costs that undoubtedly will result from our disagreements.¹

In this connection, market regulators from around the world have taken steps on a number of fronts to address those areas that are pressure points in the international regulatory context. For example, regulators are today working on matters concerning fraud, firm-specific risks, such as capital adequacy, and systemic risks, such as the clearance and settlement issues identified by the Group of 30. We are working together in a constructive way on these issues to come to a common perspective, if not always common agreement.

My focus today, however, is on but one of these pressure points, the transparency of equity securities trading across markets. That is, the trading of fungible securities

¹ See "Reconciling National and International Concerns in the Regulation of Global Capital Markets," Address by Richard C. Breeden, Chairman, SEC, bef. London School of Economics (November 8, 1991).

internationally.² The debate about the role of transparency has become very intense. The issues range from distinctions between individual versus institutional markets, agency versus principal markets, auction versus dealer markets, value investors versus professional traders, and retail versus block trades. In particular, there is great concern that enhanced transparency reduces the willingness of market makers to trade in block size.

My remarks today cannot cover all of these issues. Indeed, it is important to note that, although the principles I discuss here have general application, the specific transparency standards needed may vary depending on the nature of the individual market. Specifically, different markets with different microstructures and market participants may come to different conclusions about the role of transparency and, especially, its relationship to block trading.³

Rather than try to resolve all of these specific issues, however, today I want to outline for you why the U.S. markets have concluded that the principle of transparency is a

² This address focuses on the transparency issues that arise when home market nationals seek to trade fungible equity securities in a foreign market during the home market's primary trading hours.

³ Cf. Letter from Richard G. Ketchum, then Director, Division of Market Regulation, SEC, to William J. Anderson, Assistant Comptroller, General Government Division, U.S. General Accounting Office (May 22, 1987) [reprinted in U.S. General Accounting Office, U.S. Government Securities: An Examination of Views Expressed About Access to Broker's Services (December 1987)].

fundamental aspect of investor protection and efficient markets.⁴ If we can agree that the principle of transparency is worth pursuing, or at least agree to respect that principle once it has developed in the primary market for a security, perhaps then it will be possible to develop a framework for addressing the very difficult issues that can arise when we try to translate that principle into standards for an increasingly complex and interdependent world.

II. Definition of Transparency

For purposes of this discussion, the term transparency will be used to refer to the degree to which last sale (price and volume) and quotation information is made publicly available on a real-time basis.⁵ Although total transparency⁶ may not be

⁴ A major goal and ideal of the securities markets and the securities industry has been the creation of a strong central market system for securities of national importance, in which all buying and selling interest in these securities could participate and be represented under a competitive regime. . . . An essential characteristic of such a system would be the prompt reporting of all securities trades to the public on a comparable basis.

SEC, Letter of Transmittal, Institutional Investor Study Report XXIV-XXV, H. Doc. No. 92-64, pt. 8, 92nd Cong., 1st Sess. (1971).

⁵ In the United States, "real-time" generally means within 90 seconds of the execution of a trade.

⁶ A market providing total transparency for a security would have real-time dissemination of (1) trade price and volume of completed transactions from all markets trading that security;
(continued...)

obtainable, high levels of transparency have been achieved in various markets, most notably in the U.S. equities markets. In the United States, there is real-time dissemination of both transaction information (trade prices and volumes), and quotation information (highest bid and lowest ask) for all trades taking place in U.S. market centers (exchanges and over-the-counter ("OTC") market). The exchanges and the National Association of Securities Dealers, Inc. ("NASD") collect transaction information for equity securities, whether traded on the New York Stock Exchange ("NYSE"), on a regional exchange, or OTC, and report that information for dissemination on a consolidated basis. In addition, the exchanges and the NASD collect and transmit quotation information on such securities for dissemination on a consolidated basis. For listed securities traded on the exchanges, the size of quotations is generally quite large. In addition, the size of quotations in the OTC market is increasing.

III. Benefits of Transparency

Real-time dissemination of transaction and quotation information for the most actively traded equity securities is required in the United States because such transparency provides

⁶ (...continued)

and (2) information accurately indicating the size and price of prospective trading interest, such as firm quotations in representative size, and resting limit orders, both at the best firm bid and ask quotations, and away from such quotations.

many important benefits for investors, in particular, and the markets, in general. ⁷ These benefits can, for our purposes, be separated into three categories. First, transparency enhances investor protection. Second, by encouraging investor participation in a market, transparency promotes market liquidity. And third, transparency fosters the efficiency of securities markets by facilitating price discovery and open competition, thereby counteracting the effects of fragmentation.

Each of these benefits both promotes and is a function of the others. For example, by providing protection for investors, transparency encourages greater participation in securities markets, and therefore enhances the liquidity of those markets. This increase in liquidity, in turn, increases market efficiency.

⁷ The Conference Report on the Securities Acts Amendments of 1975 ("1975 Amendments") stated that "[c]ommunications systems, particularly those designed to provide automated dissemination of last sale reports and quotation information with respect to securities, will form the heart" of the National Market System ("NMS") to be established for the U.S. securities markets. Committee on Conference, Conference Report to Accompany S. 249: Securities Acts Amendments of 1975, H. Conf. Rep. No. 94-229, 94th Cong., 1st Sess. 93 ("Conference Report"), reprinted in, [1975] U.S. Code Cong. & Admin. News 321, 324. Accordingly, Section 11A(a)(1)(c)(iii) of the Securities Exchange Act of 1934 ("Act") sets forth as one goal of a NMS, ensuring "the availability to brokers, dealers and investors of information with respect to quotations for and transactions in securities." Moreover, this goal of the NMS reflects fundamental principles of the federal securities laws concerning the protection of investors and the maintenance of fair and orderly markets through full and fair disclosure of information relating to trading in the nation's securities markets. See Sections 2, 6(a), 6(b)(5), 9, 10, 11A(a)(1)(C), 11A(a)(2), 11A(b), 11A(c)(1)(B), 15(c), 15A(a), 15A(b)(6), 17(a) and 23(a) of the Act, 15 U.S.C. §§ 78b, 78f(a), 78f(b)(5), 78i, 78j, 78k-1(a)(1)(c), 78k-1(a)(2), 78k-1(b), 78k-1(c)(1)(B), 78q(c), 78q-3(a), 78q-3(b)(6), 78q(a) and 78w(a) (1991).

Similarly, by reducing the effects of fragmentation and increasing the pricing efficiency of securities markets, transparency also promotes the fairness of the markets.

A. Investor Protection

Experience has shown that one of the primary benefits of transparency is that it enhances investor protection and increases the actual and perceived fairness of securities markets. Transparency does this, in part, by allowing investors themselves to determine if the prices their brokers indicate they will obtain on trades are the best prices. Thus, investors are provided the information needed to protect themselves by avoiding brokers that would execute their trades at disadvantageous prices.

Transparency also allows investors to monitor, after the fact, the quality of the executions they receive. Investors, therefore, may be able to determine whether a broker-dealer took advantage of them by executing their transactions, as principal, at prices less favorable to those that could have been obtained had the broker-dealer firm acted as agent. In addition, with customer confirmations,⁸ which state the amount of commission or mark-up a broker received for a transaction, investors can compare the net price of their transactions with the prices reported in the market to determine if the net cost of their

⁸ See, e.g., Rule 10b-10, 17 C.F.R. § 240.10b-10 (1991).

transactions was reasonable. Nevertheless, it has been suggested that only displaying quotes is sufficient for investors to determine whether they have obtained best execution. This suggestion implies that market participants can be certain that the quotes are a true and complete reflection of supply and demand in that particular market. It appears, however, that quotes, while helpful and important, simply are not sufficient, in and of themselves.

Experience has shown that even where firm quotes exist, a substantial number of price sensitive transactions may take place between, or outside of, the spread. It is even helpful to know whether trades are occurring on the bid or ask side of the market. Quotes may help investors decide where and when to trade, but transaction reports help investors determine whether the quotes are reliable, and help them assess the quality of the executions they receive. In this regard, investors typically wish to know the direction of trading activity and whether there is significant trading between, or outside of, the quotes. ⁹

⁹ Even in those situations where the inside quotation is an eighth of a point (e.g., 20 to 20 1/8), last sale reports can provide useful information. For example, it would be useful for an investor to be aware of whether the preponderance of recent transactions were on the buy side (i.e., 20) or the sell side (i.e., 20 1/8) of the market. In addition, because such narrow quotation spreads generally reflect active trading interest, in those securities a greater number of transactions outside the retail size quotation (i.e., block transactions away from the market at, for example, 19 3/4) would be of interest to investors. Here, a record of recent block transactions would provide useful information in determining the appropriate discount from, or premium over, the retail size quotation for the next block trade.

Of course, increased transparency also allows regulators to better protect investors through improved regulatory surveillance of the markets. Nevertheless, regulatory surveillance is rarely an adequate substitute for real-time dissemination of market information. Reliance solely on regulatory reporting not only requires greater governmental or self-regulatory oversight, it is not as efficient as enabling investors to monitor trading for themselves. Indeed, although regulatory audit trails make it somewhat easier for governments or self-regulatory organizations to oversee the markets, given the sheer volume of trades and the diffusion of trading activity, it may be nearly impossible for those entities alone to monitor the markets sufficiently and prevent abusive trading. As U.S. Supreme Court Justice Louis D. Brandeis said in another context: "Sunlight is said to be the best disinfectant; electric light the most efficient policeman."¹⁰

B. Liquidity

In addition to enhancing investor protection, transparency increases the integrity of the securities markets and fosters investor confidence in those markets, thereby encouraging participation by investors of all kinds. Such participation increases market liquidity.

¹⁰ L. Brandeis, Other People's Money, and How the Bankers Use It 92 (Frederick A. Stokes Co. ed. 1932).

For example, greater institutional participation in the securities markets is promoted because those institutions have less reason to fear abusive trading practices such as frontrunning. Moreover, transparency decreases the risk that non-institutional investors in both the cash and derivatives markets will be picked-off by market professionals before trading information is released.¹¹ Transparency functions similarly where markets are divided into institutional and retail markets and the institutional market lacks transparency. In such situations, the potential exists for institutional market traders to enter the retail market and use undisclosed information regarding institutional market activity to trade to their own advantage. Without sufficient dissemination of market

¹¹ The argument is sometimes made that for institutional markets, there should be less concern that participants may be disadvantaged by market professionals because of a lack of transparency. This argument is based on the assumption that without the best execution concerns that may be present in a retail customer market, there is no need for real-time dissemination of market information. Proponents of this view appear to confuse "institutional" markets with "principal only" markets. In any market where some traders act as agents for others, best execution concerns will exist. Moreover, even in purely institutional markets, institutions may be acting for others who need transparency to determine whether their agents are obtaining best execution. Indeed, many of these institutions are managing other people's money as fiduciaries themselves. Finally, these arguments also implicitly favor two-tiered institutional and individual customer markets. It is not clear that this type of market structure is either the fairest or most efficient. Specifically, these arguments do not address the need of all participants to have access to the information to ensure competitive markets and efficient pricing. In any event, from the perspective of the 50 million U.S. investors who rely on the transparency of the U.S. markets, it is cold comfort to be told that only institutions are trading in opaque, foreign markets.

information, investors may believe that "the deck is stacked against them," and ultimately leave the market.

The effects of adverse information risk are not confined to investors, however. Dealers may increase their bid-ask spreads to protect themselves against the chance of trading with someone that is aware of undisclosed transaction information. The resulting higher dealing costs may, in turn, also reduce trading volume.

In short, if too much private information about trading activity exists in a securities market, the risk that one is trading with someone with superior information becomes too great, and the liquidity and pricing efficiency of that market suffers.

C. Pricing Efficiency, Market Competition, and Access

Another benefit of transparency is its ability to counteract some of the consequences of a decentralized, or "fragmented," market structure. In particular, by facilitating open access to the price discovery process, transparency is able to counteract much of the pricing inefficiency caused by fragmentation, yet still permit competition between and among markets trading fungible securities.¹² As you all know, we no

¹² See generally, Division of Market Regulation, Automated Securities Trading: A Discussion of Selected Critical Issues, Paper Presented at IOSCO 1991 Annual Meeting (September 26, 1991); Testimony of Richard C. Breeden, Chairman, SEC, before the Subcommittee on Telecommunications and Finance, U.S. House of Representatives, concerning the Government Securities (continued...)

longer live in an age where the securities markets of each country can function independently of, and in isolation from, other securities markets in the world. In the last 15 years, the world's securities markets have become increasingly linked; money managers and institutional investors now routinely look to the world's markets for alternative investment opportunities.¹³ Most important, a large and growing number of securities are no longer traded exclusively in the company's home market. Hence, multiple competitive markets now exist for most major equity securities.

Generally, the effects of this trend have been positive. New sources of capital are now available to issuers worldwide, and such linkage facilitates the global allocation of capital. With this trend, however, has also come "fragmentation" on an

¹² (...continued)

Market, September 4, 1991; Letter from Richard C. Breeden, Chairman, SEC, (enclosing memorandum from William H. Heyman, Director, Division of Market Regulation, to Richard C. Breeden, regarding Response to letter from Chairman Markey concerning Computerized Trading Systems, dated July 3, 1991), to the Honorable Edward J. Markey, Chairman, House of Representatives Subcommittee on Telecommunications and Finance (July 11, 1991); "Regulatory Challenges for the 1990's," Address by Richard G. Ketchum, then Director, Division of Market Regulation, SEC, bef. Federation Internationale des Bourses de Valeurs 11, 13 ("FIBV") (April 17, 1991) ("If we are to move further into the bold new world of an international market system, we must ensure that markets are truly transparent. . . . Accordingly, I would urge the FIBV to articulate a general principle encouraging non-primary markets for an equity security, including foreign and after-hours markets, to be no less transparent than the primary, generally home country market.").

¹³ See generally, SEC Staff, Report on the Internationalization of the Securities Markets (July 27, 1987).

international level. This fragmentation has resulted in increased diffusion of order flow, and an increase in the occurrence of the same securities being traded in different markets at different, and potentially inefficient, prices.

This pricing inefficiency is, in large part, caused by the fact that fungible securities are being traded "in the dark" -- that is, with little or no transparency for those trades. When one market permits opaque trading, it prevents other market centers from considering those trades in assessing the overall supply and demand for the securities. Consequently, determinations as to the optimal price for the securities may be inaccurate. ¹⁴

An opaque market that prices efficiently based on primary market prices is attracting order flow by "free-riding" on the price discovery of a more transparent market, without offering any transparency of its own. The net short-term result of this can be reduced efficiency and liquidity in the transparent market, and, if trading continues to migrate to the more opaque market, reduced efficiency and liquidity in all markets for the security. In the long run, this situation also harms the opaque

¹⁴ Because many trades may reflect a revised view of a company's future prospects, by having a market where trades are not disclosed on a real-time basis, the ability of market participants to adjust quickly and accurately their prices to reflect the information conveyed by trades is impaired and the pricing efficiency of the market is further reduced.

market. ¹⁵

Inefficient pricing and free riding caused by fragmentation is not simply a matter of concern on a transactional basis. The costs of such inefficiency are much more far reaching than its direct detrimental effects on a particular investor. Inefficient pricing, in the aggregate, hinders the allocation of national and global resources by distorting the price signals on which investors rely, and therefore injures not only the economies of the markets trading those securities, but also the global economy as a whole. As we all know, market economies largely rely on the prices of securities to reflect accurately underlying values so as to ensure proper allocation of new funds to the most productive areas of the economy. As a consequence of inefficient pricing, those scarce capital resources may be allocated in an economically inefficient manner. ¹⁶

These ill effects of fragmentation can, however, be avoided. The discrete and disparate market structures can, in effect, be integrated, and pricing inefficiency counteracted, without

¹⁵ Thus, "the new market can be viewed as a parasite that in the end destroys itself by sucking dry the tree upon which the parasite itself depends." See Intervention de Didier Davydoff, Chef du Service des Etudes du Developpement des Marches de la Commission des Operations de Bourse, 16th Annual Conference, International Organization of Securities Commissions (September 1991).

¹⁶ By the same account, derivative products markets, which rely on accurate pricing information from the cash markets, are directly harmed by the inability to obtain accurate pricing information relating to the underlying security, because they are unable to price efficiently the derivative products.

requiring that all order flow for a multiply-traded security be directed to a particular market. By requiring transparency for all trades, each market trading a particular security may view all trading taking place in that security, and participants in those markets can, therefore, more accurately assess the overall supply and demand for that security, and adjust their trading activity accordingly. ¹⁷

No clearer example of the ability of transparency to counteract fragmentation is available than that of the U.S. markets. The market structure of the United States may be considered decentralized. In the United States, most major securities may be simultaneously traded on any of a number of separate markets. Indeed, there co-exists in the United States several different types of market microstructures. ¹⁸ Equity securities may be traded OTC, through a dealer market -- the National Association of Securities Dealer's Automated Quotation System ("NASDAQ") -- or may be traded through one of the national

¹⁷ Cf. L. Harris, Consolidation, Fragmentation, Segmentation, and Regulation 17-19 (March 1992) ("Market diversity, however, does not necessarily imply inferior price formation and high transaction costs. The benefits of consolidation can be obtained in a fragmented market when information freely flows between market segments and when all traders do not have to trade in only one segment.")

¹⁸ The Securities Exchange Act of 1934, particularly Section 11A of that statute (which directs the SEC to facilitate the establishment of a national market system), does not express a preference for a particular market microstructure. Rather, the Act directs the Commission to ensure that all markets, auction, dealer, or hybrid, further the goals of investor protection and the promotion of fair, orderly, and efficient markets.

"order-driven" or "auction" exchanges, such as the NYSE. Further, these same securities also may be simultaneously traded on any of the regional exchanges throughout the country. Nonetheless, because transaction and quotation information is available to all of these markets on a real-time basis, investors submitting orders through any of these markets can determine the supply and demand for all equity securities. The net result is that the prices of these securities, when traded in similar size, do not significantly differ from market to market. ¹⁹

¹⁹ Congress and the Commission have found transparency to be so beneficial in terms of improving pricing efficiency, that they have moved toward increasing the transparency requirements for penny stocks, see Securities Exchange Act of 1934, § 17B, 15 U.S.C. § 78q-2 (1991), government securities, and high yield corporate debt. See Testimony of Richard C. Breeden, Chairman, SEC, before the Subcommittee on Domestic Monetary Policy, U.S. House of Representatives, concerning H.R. 3927, The Government Securities Reform Act and H.R. 4450, the Government Securities Auction Reform Act, April 28, 1992; Testimony of Richard C. Breeden, Chairman, SEC, before the Subcommittee on Telecommunications and Finance, U.S. House of Representatives concerning the Government Securities Market, September 4, 1991; Letter from Richard C. Breeden, Chairman, SEC (enclosing Report by the Division of Market Regulation on Transparency in the Market for High-Yield Debt Securities), to the Honorable Donald W. Riegle, Jr., Chairman, U.S. Senate Committee on Banking, Housing and Urban Affairs (September 6, 1991) (stating that "it may be possible and desirable to substantially improve transparency . . . for much of the high-yield bond market").

Of course, the level of transparency, if any, that is needed for trading in a particular security is dependent on numerous factors relating to the type of security and the market in which it trades.

IV. Costs of Transparency

So, what are the costs for all of these benefits? From the experience of the U.S. markets, it appears that the costs of transparency are minimal. Certainly no one argues that reporting retail transactions is harmful or overly expensive. Thus, the narrow question becomes whether a special class of market makers should be exempt from reporting block trades with institutions or other market makers.

A. Immediacy and Liquidity

The argument against transparency can be briefly summarized as follows: ²⁰ Institutions obtain immediacy and liquidity for

²⁰ It also has been argued that regulation requiring greater transparency would stifle innovation by the markets. The history of the U.S. securities markets has shown that the opposite is, in fact, true. For over 20 years, the equity markets of the United States have operated under a number of transaction and quotation reporting requirements. Yet, with some intervention by the SEC, the markets have continued to establish new and innovative systems and services. Moreover, markets may recoup expenses for disseminating transaction and quotation information through the collection of fees. Indeed, the exchanges and the NASD in the United States derive a significant portion of their revenues from fees for the supply of such information.

Increased transparency requirements in the United States also have brought meaningful innovation to the distribution of such information. Vendors have expanded, and continue to expand, their services to disseminate information on more types of securities. These vendors also now offer sophisticated analytics and graphics, provide comprehensive historical data bases on securities, provide products that can be tailored to particular customer needs, and display information in an
(continued...)

block trades because dealers are willing to buy or sell, as principal, blocks of securities from institutions who desire to sell or buy those blocks. If dealers are allowed to purchase blocks in a market where block trades are not disclosed on a real-time basis, then the dealers can sell those securities to investors who are unaware that there has been a sale of a block to the dealer.

It is argued that if the block must be disclosed on a real-time basis, dealers could be "picked-off" by their competitors (who might guess their position in the security) and the dealers generally would receive lower prices on the sale of those securities to investors. As a result, it is asserted that dealers would be less willing to risk their capital and would therefore widen their spreads for block trades or would stop making markets altogether. The result, it is believed, would be a widening of bid-ask spreads on block trades, a decrease in the immediacy provided by the market, an increase in the price volatility of blocks, and an exodus of large traders to an alternative marketplace.

Similar arguments were made in the past when the U.S. equities markets faced Commission proposals to increase transparency. For example, in the late 1970s and early 1980s, the exchanges resisted SEC proposals to require firm quote dissemination, in part because of liquidity concerns. For

²⁰ (...continued)
easier to read format. The speed and capacity of the services also have been improved.

similar reasons, the OTC market makers objected when the Commission proposed to require real-time transaction reporting for actively traded OTC securities. ²¹ It turned out, however, that these fears were misplaced. Indeed, the competitiveness and liquidity of the markets for both listed and OTC equities subject to the real-time transaction and quotation reporting requirements of the SEC have, if anything, increased since these rules were

²¹ It has been asserted that markets themselves, without involvement by regulators, can effectively determine the optimal level of transparency for the securities traded on that market, and would inevitably implement changes necessary to attain that goal. In the United States, the past 30 years have demonstrated that some intervention by a regulator is typically necessary to ensure that sufficient information is disseminated to investors. Indeed, it was the SEC, in 1963, that called for OTC systems "designed to show generally . . . the best prevailing interdealer bid and ask quotations." And, it was the SEC that stated "there is on the horizon the likelihood of a computer system that would assemble all interdealer quotations and instantaneously determine and communicate best quotations for particular securities at any time. If such a system were established, the further possibility of using it in connection with executions and to compile actual price and volume data for [OTC] transactions would exist." SEC Staff, Report of Special Study of Securities Markets, 677-78, H. Doc. No. 95, pt.2, 88th Cong., 1st Sess. (1963). It was, in part, the inaction of the U.S. securities markets regarding dissemination of transaction and quotation information that led to the 1975 Amendments. See Report of the Comm. on Banking, Housing and Urban Affairs to Accompany S.249, S. Rep. No. 94-75, 94th Cong., 1st Sess. (1975). The SEC subsequently adopted a number of rules to require greater and more efficient dissemination of transaction and quotation information. See, e.g., Rule 11Ac1-2, 17 C.F.R. § 240.11Ac1-2 (1991) (Display of Transaction Reports, Last Sale Data, and Quotation Information); Rule 11Aa2-1, 17 C.F.R. § 240.11Aa2-1 (1991) (Designation of National Market System Securities); Rule 11Aa3-1, 17 C.F.R. § 240.11Aa3-1 (1991) (Dissemination of Transaction Reports and Last Sale Data with respect to Transactions in Reported Securities); Rule 11Ac1-1, 17 C.F.R. § 240.11Ac1-1 (1991) (Dissemination of Quotations for Reported Securities).

adopted.²² Thus, the feared loss of immediacy should not be a reason to reduce transparency, at least for highly liquid securities like U.S. equities.

But, let us assume, as many dealers believe, that reporting block trades will reduce the willingness of dealers to quote in size.²³ Even then, questions still would remain. Is the ability of dealers to profit from such secret trading net beneficial to the market as a whole? Are such opportunities consistent with basic notions of investor protection?

²² See "Automation and Electronic Trading: Key Issues for Regulating in a New Era," Address by Joseph Hardiman, President and CEO, National Association of Securities Dealers, Inc., 16th Annual Conference, International Organization of Securities Commissions 4, 8 (September 1991) ("Identifying an international consensus regarding, at least, minimum standards of reporting and dissemination of quotation and transaction information to regulatory organizations and to the public becomes increasingly desirable. There must be transparent prices through public dissemination of consolidated quotation and transaction information."); Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC, at 3 (July 26, 1991) (disclosure of trading activity is a "basic tenet of investor protection.").

Further, it may be argued that "if the block is fairly priced, disclosure of that price might encourage traders to buy. In the U.S. markets, prices tend to rebound from the block price, thereby giving buyers of blocks a positive return and an incentive to participate." Huang & Stoll, Major World Equity Markets: Current Structure and Prospects For Change 16 Monograph Series in Fin. & Econ., 1991-3.

²³ Hardiman, id. at 5, ("While transparent markets may offer a number of market-wide benefits, there is no question that dealers, if provided a choice, will prefer to execute many institutional trades without public dissemination.").

B. Informationless Trades

In answer to these questions, it has been argued that investors are not disadvantaged by opacity, because, allegedly, a large percentage of block trades are so-called "informationless" trades,²⁴ which are trades not based on information relating to the value of the underlying company, but rather are "liquidity" trades. That is, for example, arbitrage trades between cash and derivatives, or the result of program trading.

To begin, it is not clear that, in fact, most trades are informationless. Further, as I mentioned earlier, hiding trades in block size from the rest of the market, reduces the pricing efficiency of the market. Also, it seems that the determination as to the value of the information, if any, that is conveyed by a trade is more appropriately made by each investor, rather than a regulator or a market. Moreover, if these trades truly are "informationless," then full disclosure should not be detrimental.

²⁴ Personally, I believe the concept of an "informationless trade" is not useful. Indeed, this is one example of a situation where the jargon itself obfuscates, rather than furthers, careful analysis. Every trade conveys some information, if only the fact that it occurred. Trades may convey relatively more or less information to different traders and investors. The relevant inquiry is how much and what types of information. For example, even if a trade conveyed relatively less information about the valuation of a particular security, it might convey information about the valuation of the equity asset class as a whole. See generally Gammill & Perold, The Changing Character of Stock Market Liquidity, 15 J. Portfolio Mgmt. 13 (Spring 1989).

C. Temporary Price Changes

It also is asserted, however, that investors are not harmed by the lack of block-trade reporting, because the price normally would rebound after a block trade. This rebound effect reflects a "temporary" price change rather than a "permanent" price change caused by adverse information about the company. Thus, by hiding block trades, dealers, in effect, gain the advantage of the "temporary" price change attributed to "price pressure" or "liquidity costs," and avoid the competition (which is characterized as "spoiling activities") of other dealers. The customer is portrayed as paying the "permanent price," and this is not seen to be disadvantageous.

It should be recognized, however, that price pressure and liquidity costs are really the forces of supply and demand. Thus, the effects of both are likely to be felt regardless of whether block trades are disclosed on a real-time basis. Once that is understood, it should be clear that attempting to distinguish between "permanent" and "temporary" price changes is not useful. Moreover, divining between the two is clearly impractical. For those who trade at a price that does not reflect the forces of supply and demand, either receive a windfall or pay a disadvantageous price, which must be considered permanent. Public investors are most likely to suffer the permanent economic loss. More fundamentally, however, we know from the U.S. experience that a fair, efficient, and liquid

market can exist with high transparency. Indeed, as I have just argued, greater transparency ultimately encourages greater market participation and the liquidity that permits block trading to occur. Hence, it is not apparent that there is a significant cost to the market as a whole from the real-time disclosure of block trading information.²⁵ Rather, the real problem appears to relate to the appropriate allocation of costs -- there is no free lunch, no free ride.

When dealers are able to purchase blocks of securities as principals without disclosing those transactions, and then sell those securities in the market at a profit, or shed the exposure in a derivative market, the cost is borne by the uninformed investor or the derivative market participant. In an opaque market, where dealer trades are not disclosed, the customer, in essence, may be subsidizing the dealer's block trading activities. It is not obvious why retail investors (or for that matter, other institutional investors or derivative market makers) should bear these costs. While dealers may supply a temporary source of liquidity, the ultimate source of liquidity in a market is the value investor with whom the dealer must unwind his position.

Thus, while I fully recognize the difficulty that

²⁵ Indeed, Ketchum, supra note 12 at 13, warned that if we deviate from the transparency principle, we not only "will do so at a terrible cost to market efficiency and effective supervision, we will also lend our support to an environment that calls into question the future role in international securities trading of organized securities markets."

transparency poses in attempting to unwind a block position, it seems inherently unfair, and contrary to all fiduciary principles, to design a disclosure system for the purpose of benefiting professional intermediaries at the expense of unsuspecting customers. ²⁶ As I have noted throughout this speech, once the ultimate suppliers of liquidity, the customers, fully understand the disadvantages at which they operate in an opaque market, the liquidity of that market may be degraded. ²⁷ Moreover, such a result would be especially unfortunate if it were based on the false dichotomy between transparency and liquidity.

²⁶ See Huang & Stoll, supra note 22 at 16, ("The failure to disclose block trades disadvantages public investors who trade at unfair prices. [T]he block is traded by the dealer at the wrong price and then sold to the unsuspecting public at the wrong price. It would be preferable to negotiate before the block and determine a fair price that could immediately be disclosed to the public. If the risk is great, the price of the block can incorporate a discount for that risk.").

²⁷ Ultimately market confidence will be injured when retail and other investors realize that institutions and professional investors are provided significant access to privileged information. For example, following the recent disclosures in Japan it has been suggested that one way of increasing investor confidence might be to embark on "the task of building a transparent and fair securities market." See "Tasks Facing the Securities Industry in 1992: A Year for Regaining Investor Confidence and for Spurring the Market," Address by Yutaka Orida, Chairman of Standing Committee, Conference for Securities Associations (February 1992).

V. Conclusion

In conclusion, I believe it is possible to have both a fair and efficient market with substantial transparency. Indeed, I believe broad transparency is one of the reasons the U.S. markets have such breadth and depth of participation. Conversely, I believe that if we sacrifice or impair such fairness and efficiency in the name of liquidity, ultimately it will impair efforts to develop globally competitive capital markets which compete on price and quality of service.

Thank-you for your kind attention.