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SECURITIES AND EXCHANGE COMMISSION
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Speech to the
Compliance and Legal Seminar
Sponsored by the
Securities Industry Association
Sarasota, Florida - March 20, 1978

THE RESOLUTION OF BROKER-DEALER CONFLICTS OF INTEREST IN MARKET EXECUTIONS

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SPEECH TO THE
COMPLIANCE AND LEGAL SEMINAR
SPONSORED BY THE
SECURITIES INDUSTRY ASSOCIATION
SARASOTA, FLORIDA -- MARCH 20, 1978

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GOOD MORNING. I WAS PLEASED AND HONORED WHEN YOU ASKED ME TO GIVE THIS KEYNOTE ADDRESS. I HAVE MANY FRIENDS AND FORMER COLLEAGUES AT THIS CONVENTION AND I AM GLAD TO SEE YOU. IN MY NEW ROLE AS A PUBLIC OFFICIAL I TRULY NEED THE CRITICISM AND SUPPORT WHICH IS EASIEST TO ACCEPT FROM VALUED FRIENDS OF LONG STANDING. BUT THERE IS ONE FRIEND WHO IS NOT WITH US THIS YEAR, AND I AM SURE THAT THOSE OF YOU WHO KNEW HIM MISS HIM AS I DO.

ALTHOUGH IT IS A SMALL TRIBUTE TO A MAN WHOSE COURAGE AND HUMANITY WERE VERY GREAT, I WOULD LIKE TO DEDICATE THIS ADDRESS TO THE MEMORY OF THAT MISSING FRIEND -- HOWARD A. BERNSTEIN, WHO DIED LAST OCTOBER. WHEN I WAS ON THE STAFF OF THE NEW YORK REGIONAL OFFICE OF THE SEC, HOWARD WORKED FOR ME AS AN ATTORNEY AND THEN AS A BRANCH CHIEF. SUBSEQUENTLY, HE BECAME A PARTNER IN A BROKERAGE FIRM AND I BECAME A PARTNER IN A LAW FIRM, AND I WORKED FOR HOWARD WHO WAS THEN MY CLIENT.

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DURING THOSE YEARS HOWARD ALWAYS DEMONSTRATED LOYALTY, GOOD JUDGMENT AND INTEGRITY. THEREFORE, I WAS ABLE TO GIVE HIM THAT RESPECT WHICH IS CRUCIAL TO AN ORDERLY SOCIETY BUT FAR TOO RARE IN MOST OF OUR RELATIONSHIPS -- I TRUSTED HOWARD WITHOUT ANY RESERVATIONS. HOWARD'S DEATH WAS PREMATURE AND PAINFUL. I MISS HIS INTERESTING GOSSIP AND WONDERFUL SENSE OF HUMOR AS WELL AS HIS WISDOM. OUR COMMUNITY HAS LOST THE GOOD COMPANY OF A TRULY SOCIAL HUMAN BEING.

I WANTED TO SPEAK TO YOU ABOUT HOWARD TODAY TO MEET A PERSONAL NEED AND ALSO TO COMMUNICATE MY SENSE THAT WALL STREET IS THE PEOPLE WHO WORK IN THE SECURITIES INDUSTRY. AS OUR BUSINESSES BECOME BIGGER, OUR TECHNOLOGY MORE ADVANCED AND OUR LAWS MORE COMPLICATED, I AM FEARFUL THAT WE ARE DIMINISHING THE VALUE OF THE INDIVIDUAL, WHO PROVIDES THE GENIUS IN THE SECURITIES INDUSTRY AND IN OUR CIVILIZATION. AS THE WALL STREET COMMUNITY IS TRANSFORMED FROM FAMILY PARTNERSHIPS TO LARGE PUBLIC CORPORATIONS, I AM FEARFUL THAT WE ARE UNDERMINING THE TRUST UPON WHICH OUR SECURITIES MARKETS DEPEND.

AS ALL OF YOU KNOW, IN 1975 THE CONGRESS DIRECTED THE SECURITIES INDUSTRY TO ESTABLISH, AND THE SECURITIES AND EXCHANGE COMMISSION TO FACILITATE THE ESTABLISHMENT OF, A NATIONAL MARKET SYSTEM FOR THE TRADING OF SECURITIES IN THE

SECONDARY MARKETS. IN JANUARY OF THIS YEAR, THE SEC ISSUED A STATEMENT ON THE DEVELOPMENT OF A NATIONAL MARKET SYSTEM WHICH OUTLINED A SERIES OF POSSIBLE RULEMAKING PROCEEDINGS FROM WHICH THE LEGAL FRAMEWORK FOR A NATIONAL MARKET SYSTEM COULD BE BUILT. THIS MORNING, I WOULD LIKE TO SHARE WITH YOU MY THOUGHTS AND CONCERNS ABOUT THE SPECIALIST/MARKET-MAKER IN THE NATIONAL MARKET SYSTEM, AND THE IMPORTANCE OF THE RESOLUTION OF BROKER-DEALER CONFLICTS OF INTEREST IN THE MARKET-MAKING FUNCTION.

SINCE I ARRIVED AT THE SEC LAST FALL, I HAVE BEEN DEEPLY CONCERNED ABOUT THE DEVELOPMENT OF A NATIONAL MARKET SYSTEM. ALTHOUGH THE NATIONAL MARKET SYSTEM, AS ENVISIONED IN THE 1975 AMENDMENTS AND ELABORATED UPON IN THE COMMISSION'S JANUARY STATEMENT, IS NOW GOVERNMENTAL POLICY, IT IS NOT INAPPROPRIATE TO CONTINUE TO TEST OUR EMERGING RULEMAKING PROPOSALS AGAINST AN ARTICULATED PUBLIC INTEREST. WILL THE MOST CURRENT PROPOSALS BY THE SEC RESULT IN APPROPRIATE SOLUTIONS TO REAL NEEDS? OR ARE THOSE INITIATIVES THE OUTPUT OF GOVERNMENT OFFICIALS TRYING TO MAKE A RECORD OF THEIR ACCOMPLISHMENTS IN A COMPETITIVE SOCIETY WHICH GIVES PRIZES FOR NEW PRODUCTS? IS INDUSTRY RESISTANCE TO THE IMPLEMENTATION OF A NATIONAL MARKET SYSTEM A VALID EFFORT TO PROTECT A WELL-FUNCTIONING MARKET MECHANISM? OR IS IT THE INSULAR SELF-PROTECTIONISM OF A MEDIEVAL GUILD TRYING TO HOLD BACK COMPETITION? I AM TROUBLED BY THESE

QUESTIONS BECAUSE THE ANSWERS ARE NOT ALWAYS READILY APPARENT. IN PARTICULAR, ALTHOUGH I RECOGNIZE THAT WE MUST MOVE FORWARD TO A MODERNIZED, NATIONWIDE, AND PERHAPS EVEN INTERNATIONAL, MARKETPLACE, I AM CONCERNED ABOUT WHAT WE ARE DESTROYING IN THE NAME OF PROGRESS TOWARD OUR GOAL.

TO RECALL SOME HISTORY, THE SECURITIES LEGISLATION OF THE 1970'S WHICH STARTED WITH THE SECURITIES INVESTOR PROTECTION ACT, WAS AN END-PRODUCT OF THE BROKER-DEALER BANKRUPTCIES OF THE LATE SIXTIES. THE 1975 AMENDMENTS WHICH ATTEMPTED TO SOLVE THE SERIOUS ECONOMIC DISLOCATIONS OF THE 1960'S, WERE A SERIES OF LEGISLATIVE COMPROMISES COMPELLED BY A FRAGMENTED INDUSTRY. SOME OF THE PROBLEMS OF THE SIXTIES ARE STILL WITH US. OTHERS HAVE BEEN SUPERSEDED BY THE PROBLEMS OF THE SEVENTIES.

THE FIXED MINIMUM COMMISSION SCHEDULE WAS UNREALISTICALLY HIGH AND PRODUCED ABSURD PROFITS WHICH WERE ESPECIALLY EXCESSIVE SINCE THEY WERE NOT REINVESTED IN THE SECURITIES INDUSTRY. UNFIXED RATES HAVE LED TO DISTURBING CONCENTRATION IN THE BROKERAGE BUSINESS, POORER SERVICE FOR INSTITUTIONAL INVESTORS AND HIGHER RATES FOR INDIVIDUAL INVESTORS RELATIVE TO OTHER INVESTORS. THE NEGOTIATED BLOCK MARKETS WHICH DEVELOPED IN RESPONSE TO INSTITUTIONAL TRADING WERE NOT, AND STILL ARE NOT, ADEQUATELY AND EFFICIENTLY INTEGRATED WITH THE PUBLIC AUCTION

MARKETS ON EXCHANGE FLOORS. ALTHOUGH LIQUIDITY SEEMS TO BE A QUALITY BEST PERCEIVED BY THE BEHOLDER, I FREQUENTLY HEAR THAT MARKETS ARE GETTING LESS LIQUID RATHER THAN MORE LIQUID. BUT OUR MOST SERIOUS PROBLEM OF TODAY IS THE SUBTLE BUT INVIDIOUS DISTRUST OF OUR FINANCIAL INSTITUTIONS AND OUR MARKET MECHANISMS WHICH HAS CREPT INTO OUR VIEWS ON MARKET STRUCTURE.

WHATEVER THE NATIONAL MARKET SYSTEM IS AS A CONCEPT OR IDEAL, AND WHATEVER IT BECOMES AS A REALITY, THE NATIONAL MARKET SYSTEM MUST ENJOY THE TRUST AND CONFIDENCE OF THE SECURITIES INDUSTRY, THE GOVERNMENT, AND MOST IMPORTANTLY, THE PUBLIC. ALTHOUGH OUR MARKET MECHANISMS MUST BE MODERNIZED, AND WE MUST UTILIZE TECHNOLOGY TO SOLVE THE STILL OPEN CHALLENGES OF INSTITUTIONAL DOMINATION OF THE TRADING MARKETS, WE MUST NOT LOSE FAITH IN THE PEOPLE WHO OPERATE AND USE OUR MARKET MECHANISMS. THE EXTENT TO WHICH WE TRUST THESE PEOPLE DEPENDS UPON OUR EVALUATION OF THEIR ABILITY, JUDGMENT AND INTEGRITY. THAT EVALUATION IS A MORAL AS WELL AS A BUSINESS ASSESSMENT, AND INCLUDES AN ETHICAL JUDGMENT OF HOW WELL A MARKET PARTICIPANT RESOLVES CONFLICTS BETWEEN SELF-INTEREST AND OBLIGATIONS TO THE MARKET PLACE.

FOR THIS REASON, I WISH TO TURN YOUR ATTENTION TO THE CONSIDERATION OF THE PERSON WHO WILL BE AT THE CENTER OF THE NATIONAL MARKET SYSTEM -- THE SPECIALIST/MARKET MAKER IN QUALIFIED SECURITIES. IF I MAY COIN A PHRASE, I WOULD LIKE

TO CALL THAT PERSON A "QUALIFIED SPECIALIST". THERE ARE AT LEAST THREE EXTANT MODELS FOR THE QUALIFIED SPECIALIST -- THE UNITARY STOCK EXCHANGE SPECIALIST; THE OVER-THE-COUNTER MARKET MAKER; AND THE SPLIT BOARD BROKER/MARKET MAKER ON THE CHICAGO BOARD OPTIONS EXCHANGE, INCORPORATED ("CBOE"). IN EXAMINING THESE MODELS, I WISH TO FOCUS ON HOW CONFLICTS OF INTEREST BETWEEN THE BROKER AND DEALER FUNCTIONS ARE RESOLVED TODAY, AND HOW THEY MAY BE RESOLVED FOR THE QUALIFIED SPECIALIST IN A NATIONAL MARKET SYSTEM.

BECAUSE THE SEC HAS SPENT OVER 40 YEARS RESOLVING THE BROKER AND DEALER CONFLICTS OF INTEREST ON EXCHANGE FLOORS, AND BECAUSE THE VOLUME OF TRADING ON STOCK EXCHANGES FAR EXCEEDS OVER-THE-COUNTER TRADING VOLUME, I WILL PRIMARILY TALK ABOUT THE STOCK EXCHANGE SPECIALIST SYSTEM. IN MY OPINION, THE SPECIALIST SYSTEM IS INSUFFICIENTLY UNDERSTOOD AND INSUFFICIENTLY APPRECIATED, ESPECIALLY BY THE GENERAL PUBLIC. THE SPECIALIST MAY WELL BE THREATENED BY EXTINCTION BY GOVERNMENT FIAT SIMILAR TO THAT WHICH APPEARS READY TO BEFALL THE FLOOR TRADER. THEREFORE, ONE OF MY PURPOSES IN FOCUSING UPON THE REGULATION OF THE STOCK EXCHANGE SPECIALIST IN THE CONTEXT OF BROKER-DEALER CONFLICTS OF INTEREST IS TO SUGGEST THAT THE DEMISE OF THE SPECIALIST IN THE NATIONAL MARKET SYSTEM WOULD POSE SERIOUS REGULATORY CONCERNS WHICH COULD LEAD TO LIMITED OR COMPLETE BROKER-DEALER SEGREGATION IN MARKET EXECUTIONS.

AS AN AGENT, THE SPECIALIST SERVES AS A "BROKER'S BROKER," ACCEPTING ORDERS TO BUY AND SELL SECURITIES AT PRICES WHICH ARE BELOW OR ABOVE THE THEN CURRENT MARKET PRICE FOR THOSE SECURITIES. IN THIS CAPACITY, THE SPECIALIST MAINTAINS A CENTRAL REPOSITORY OF ORDERS -- HIS "BOOK" -- AND EXECUTES ORDERS ENTRUSTED TO HIM AGAINST OTHER ORDERS TO BUY AND SELL WHICH LATER ENTER THE MARKET. AS A DEALER, THE SPECIALIST IS OBLIGATED TO ENGAGE IN A COURSE OF BUYING AND SELLING SPECIALITY STOCKS FOR HIS OWN ACCOUNT, COMMITTING HIS CAPITAL TO HELP ASSURE A "FAIR AND ORDERLY" MARKET FOR THOSE STOCKS.

THE SPECIALIST'S FUNCTIONS OF ACTING AS A DEALER FOR HIS OWN ACCOUNT AND AS A BROKER FOR OTHERS INVOLVE HIM IN MANIFOLD INHERENT CONFLICTS BETWEEN SELF-INTEREST AND THE INTERESTS OF THOSE TO WHOM HE OWES A FIDUCIARY DUTY. FURTHER, HIS EXCLUSIVE ACCESS TO HIS BOOK RAISES QUESTIONS OF FAIRNESS TO THE MARKETPLACE. ACCORDINGLY, CONTINUATION OF THE SPECIALIST'S PRIVILEGES HAS BEEN CONDITIONED ON THE IMPOSITION OF REGULATIONS TO ASSURE THAT IN TRADING FOR HIS OWN ACCOUNT HE USES THOSE PRIVILEGES FOR THE BENEFIT OF THE MARKET GENERALLY AND NOT SOLELY FOR HIS PERSONAL ENRICHMENT.

THE SPECIALIST HAS BEEN ACCORDED THE PRIVILEGES WHICH HE ENJOYS ON THE THEORY THAT HE IS ACCOUNTABLE TO THE EXCHANGE COMMUNITY AND THE INVESTING PUBLIC FOR THE QUALITY OF EXCHANGE

MARKETS IN THE SECURITIES IN WHICH HE IS REGISTERED. THUS, HE IS RESPONSIBLE FOR FOSTERING AND ACTING TO MAINTAIN LIQUID AND CONTINUOUS TWO-SIDED AUCTION MARKETS ON THE EXCHANGE FLOOR IN THOSE SECURITIES.

I WILL TURN NOW TO AN ANALYSIS OF THE REGULATIONS WHICH HAVE EVOLVED FOR RESOLVING THE CONFLICTS IN THE SPECIALIST'S FUNCTIONS. NEGATIVE OBLIGATIONS HAVE CURTAILED THE SPECIALIST'S ABILITY TO TAKE UNDUE ADVANTAGE OF OTHER MARKET PARTICIPANTS. AFFIRMATIVE OBLIGATIONS HAVE BEEN IMPOSED AS A CONDITION OF PRIVILEGED ACCESS TO THE SPECIALIST'S BOOK. I SHOULD NOTE THAT OVER-THE-COUNTER MARKET-MAKERS ALSO HAVE CONFLICTS OF INTEREST AND TIME-AND-PLACE ADVANTAGES, AND THE SEC HAS HAD TO CONSIDER REGULATION OF ALL TYPES OF MARKET-MAKERS.

IN THE SECURITIES EXCHANGE ACT OF 1934 ("EXCHANGE ACT"), CONGRESS VESTED THE COMMISSION WITH AUTHORITY TO REQUIRE THE SEGREGATION OF A SPECIALIST'S BROKER AND DEALER FUNCTIONS OR,

ALTERNATIVELY, TO PERMIT THE CONTINUATION OF THOSE COMBINED FUNCTIONS INSOFAR AS THE COMMISSION'S RULES REQUIRED THE SPECIALIST TO RESTRICT HIS DEALER ACTIVITIES, TO THE EXTENT PRACTICABLE, TO THOSE REASONABLY NECESSARY TO PERMIT HIM TO MAINTAIN A "FAIR AND ORDERLY" MARKET. IN ADDITION, THE COMMISSION WAS DIRECTED BY CONGRESS TO CONDUCT A STUDY OF THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF BROKER AND DEALER.

SINCE THE CONTINUATION OF THE SPECIALIST SYSTEM AND THE REGULATION OF SPECIALISTS ARE JUSTIFIED ON THE THEORY THAT THE SPECIALIST'S ACTIVITIES MAINTAIN A FAIR AND ORDERLY MARKET, I WOULD LIKE TO TAKE AN ASIDE TO STATE WHAT "FAIR" AND "ORDERLY" MEAN IN THIS CONTEXT. AS USED IN THE REPORT OF SPECIAL STUDY OF THE SECURITIES MARKETS ("SPECIAL STUDY") AND AS ADOPTED BY THE NEW YORK STOCK EXCHANGE, INC., ("NYSE") IN ITS SPECIALIST JOB DESCRIPTION:

> "A 'FAIR' MARKET IS ONE WHICH IS FREE FROM MANIPULATIVE AND DECEPTIVE PRACTICES AND WHICH AFFORDS NO UNDUE ADVANTAGE TO ANY OF THE PARTICIPANTS THEREIN. AN 'ORDERLY' MARKET IS ONE WITH REGULARITY AND RELIABILITY OF OPERATION MANIFESTED BY THE PRESENCE OF PRICE CONTINUITY AND DEPTH EXHIBITED BY THE AVOIDANCE OF LARGE AND UNREASONABLE PRICE VARIATIONS BETWEEN CONSECUTIVE SALES, AND THE AVOIDANCE OF OVERALL PRICE MOVEMENTS WITHOUT APPROPRIATE ACCOMPANYING VOLUME."

SOON AFTER PASSAGE OF THE EXCHANGE ACT, AND BEFORE COMPLETION OF ITS STUDY ON BROKER-DEALER SEGREGATION, THE COMMISSION DRAFTED A SET OF SIXTEEN RULES TO GOVERN TRADING UPON EXCHANGES. A MAJOR PURPOSE OF THOSE RULES WAS THE PREVENTION OF OVERREACHING BY THOSE ACTING AS BOTH BROKERS AND DEALERS. THE RULES CODIFIED WELL-ESTABLISHED PRECEPTS OF FIDUCIARY LAW PRECLUDING A FIDUCIARY FROM PREFERRING HIS INTEREST OVER THOSE OF HIS PRINCIPAL. ADDITIONALLY, ONE RULE, THE "UNIFORM SPECIALIST RULE," REITERATED THE "NEGATIVE OBLIGATION" OF SPECIALISTS MANDATED BY THE ACT -- THAT IS, A SPECIALIST MUST LIMIT HIS DEALER ACTIVITIES TO THOSE REASONABLY NECESSARY TO MAINTAIN A FAIR AND ORDERLY MARKET.

IN RESPONSE TO CONGRESSIONAL MANDATE, IN 1936 THE COMMISSION PUBLISHED ITS REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGRETATION OF THE FUNCTIONS OF DEALER AND BROKER ("SEGREGATION REPORT"). ALTHOUGH THE SEGREGATION REPORT DISCUSSED ALL BROKER-DEALERS, I WILL DISCUSS ITS CONCLUSIONS WITH RESPECT TO SPECIALISTS. WHILE RECOGNIZING THE CONFLICTS OF INTEREST INHERENT IN HIS FUNCTIONS, THE COMMISSION CONCLUDED UPON THE EVIDENCE THEN BEFORE IT THAT SEGREGATION SHOULD NOT BE MANDATED. BASIC TO THIS CONCLUSION WAS THE COMMISSION'S FINDING THAT, DURING THE PERIOD STUDIED, SPECIALIST TRADING, TAKEN AS A WHOLE, DID NOT APPEAR TO ACCENTUATE PRICE TRENDS, BUT INSTEAD APPEARED GENERALLY TO COUNTER TEMPORARY IMBALANCES IN PUBLIC SUPPLY AND DEMAND, THUS CONTRIBUTING TO THE CONTINUITY

AND ORDERLINESS OF THE MARKET. HOWEVER, THE SEGREGATION REPORT RECOMMENDED RESTRICTIONS ON THE ABILIITY OF THE SPECIALIST TO TRADE WITH HIS BOOK.

AS WE DISCUSS THE ROLE OF THE QUALIFIED SPECIALIST IN THE NATIONAL MARKET SYSTEM IN THE MONTHS AHEAD, WE WOULD ALL BE WELL ADVISED TO ADOPT THE SAME RESPONSIBLE AND CAUTIOUS ATTITUDE WHICH THE SEC ADOPTED IN ITS 1936 SEGREGATION REPORT. THE COMMISSION THERE POINTED OUT THAT DESPITE INGRAINED INVESTOR RESPECT FOR MARKET CONTINUITY, WE SHOULD NOT MAKE A FETISH OF LIQUIDITY BECAUSE AN "OVEREMPHASIS UPON LIQUIDITY IN OUR STOCK MARKETS IS FRAUGHT WITH GRAVE DANGERS TO OUR ECONOMIC SYSTEM." AT THE SAME TIME, THE COMMISSION RECOGNIZED THE IMPORTANCE OF ENCOURAGING A SUFFICIENT AMOUNT OF SPECULATIVE DEALER ACTIVITY TO MAINTAIN THE LIQUIDITY NECESSARY FOR A SAFE AND SOUND ECONOMY.

IN 1936 THE COMMISSION REFUSED TO ABOLISH THE EXCHANGE SPECIALIST SYSTEM BY RECOMMENDING SEGREGATION OF BROKER AND DEALER FUNCTIONS BECAUSE IT FELT UNABLE TO PREDICT OR CONCLUDE

WHAT AMOUNT OF DEALER ACTIVITY WAS NECESSARY TO MAINTAIN AN APPROPRIATE STANDARD OF LIQUIDITY. THEREFORE, THE COMMISSION DECIDED TO TAKE AN EVOLUTIONARY REGULATORY APPROACH WITH RESPECT TO THE SPECIALIST, STATING:

> "BY SUCH AN APPROACH, EFFECTS UPON LIQUIDITY, CONTINUITY, AND STABILITY CAN BE MEASURED AND GAGED AS ACTION TAKEN, AND ADJUSTMENTS MADE IN THE LIGHT OF EXPERIENCE ACQUIRED. EMERGENCIES MAY WELL JUSTIFY A COMPREHENSIVE COURSE OF ACTION BASED MORE ON MORAL AND ECONOMIC FAITHS THAN ON RATIONAL DEDUCTIONS; BUT IN THE ABSENCE OF SUCH A COMPULSIVE DEMAND FOR A COMPREHENSIVE PROGRAM OF IMMEDIATE ACTION, THE PROCESSES OF TRIAL AND ERROR SEEM THE COURSE OF WISDOM." SEGREGATION REPORT 101-102 (1936).

THE COMMISSION DID NOT THEREAFTER COMPREHENSIVELY RE-EXAMINE THE PROBLEMS RAISED BY THE SPECIALIST'S DUAL ROLE OR THE FEASIBILITY OF SEGREGATING HIS FUNCTIONS UNTIL THE SPECIAL STUDY IN 1963. A BASIC CONCLUSION OF THE SPECIAL STUDY WAS THAT THE SPECIALIST SYSTEM, WITH ITS COMBINED BROKER AND DEALER FUNCTIONS, "APPEARS TO BE AN ESSENTIAL MECHANISM FOR MAINTAINING CONTINUOUS AUCTION MARKETS AND, IN BROAD TERMS, APPEARS TO BE SERVING ITS PURPOSES SATISFACTORILY."

THEREFORE, THE COMMISSION IN 1963 AGAIN DECLINED TO RECOMMEND SEGREGATION OF THE SPECIALIST'S FUNCTIONS. THE SPECIAL STUDY DETERMINED THAT THE SPECIALIST'S BROKERAGE ACTIVITIES WERE A SUBSTANTIAL SOURCE OF INCOME AND THEREFORE

PROVIDED A CONTINUOUS SOURCE OF CAPITAL AND INCENTIVE FOR THE SPECIALIST TO PERFORM HIS MARKET-MAKING ACTIVITIES. THE SPECIAL STUDY FOUND THIS A COMPELLING REASON TO REJECT SEGREGATION, NOTWITHSTANDING THE ADDITIONAL FINDING THAT A SPECIALIST'S DEALER ACTIVITIES ALSO GENERALLY PROVIDED A STEADY PROFIT DURING THE PERIOD STUDIED. THE SPECIAL STUDY ALSO FOUND THAT INVESTOR EXPECTATIONS, CREDIT ARRANGEMENTS, AND THE VERY STRUCTURE OF THE EXCHANGE MARKETS, TO ONE EXTENT OR ANOTHER, REVOLVED AROUND THE MARKET-MAKING ACTIVITIES OF THE SPECIALIST.

WHILE FINDING THE SPECIALIST SYSTEM TO BE GENERALLY SOUND, THE SPECIAL STUDY, RECOMMENDED SEVERAL MEASURES TO FURTHER DEFINE THE CIRCUMSTANCES UNDER WHICH A SPECIALIST MAY COMBINE HIS PRINCIPAL AND AGENCY ACTIVITIES. OF PARTICULAR RELEVANCE TO THE RESOLUTION OF CONFLICTS OF INTEREST, THE SPECIAL STUDY RECOMMENDED THAT SPECIALISTS AND THEIR FIRMS BE PROHIBITED FROM DOING A RETAIL BUSINESS AND THAT POLICIES BE FORMULATED TO PREVENT SPECIALISTS FROM TRADING WITH THE BOOK AT UNFAIR PRICES, ESPECIALLY WHERE A SPECIALIST TRADES IN ANTICIPATION OF A PENDING BUY OR SELL ORDER OF BLOCK SIZE. OF ADDITIONAL IMPORTANCE, THE SPECIAL STUDY URGED THAT AN "AFFIRMATIVE OBLIGATION" BE IMPOSED UPON SPECIALISTS, REQUIRING THEM IN CERTAIN CIRCUMSTANCES TO COMMIT THEIR CAPITAL AND

TRADE FOR THEIR OWN ACCOUNT AGAINST THE PRICE TREND. SPECIALISTS WOULD THEREBY EASE TEMPORARY IMBALANCES BETWEEN SUPPLY AND DEMAND AND LEND CONTINUITY AND DEPTH TO THE MARKET.

IN RESPONSE TO THESE AND OTHER RECOMMENDATIONS, THE COMMISSION IN 1965 ADOPTED RULE 11B-1, WHICH REQUIRES THAT AN EXCHANGE WITH A SPECIALIST SYSTEM ADOPT RULES TO IMPOSE, AMONG OTHER THINGS, AFFIRMATIVE AS WELL AS NEGATIVE DEALER OBLIGATIONS UPON SPECIALISTS. THE REGIONAL EXCHANGES HAVE BEEN EXEMPTED FROM THE APPLICATION OF RULE 11B-1; THUS ONLY THE NEW YORK AND AMERICAN STOCK EXCHANGES ARE SUBJECT TO ITS REQUIREMENTS. FOR THE NYSE, THE GENERAL "NEGATIVE" AND "AFFIRMATIVE" DEALER OBLIGATIONS OF A SPECIALIST ARE SET FORTH IN THE EXCHANGE'S RULE 104. UNDER THAT RULE A SPECIALIST IS OBLIGATED TO TRADE FOR HIS OWN ACCOUNT OR TO REFRAIN FROM SUCH TRADING, AS CIRCUMSTANCES MAY WARRANT, IN ORDER TO MAINTAIN A FAIR AND ORDERLY MARKET IN HIS STOCK. FURTHER, PARTICULAR RULES HAVE BEEN FASHIONED TO LIMIT THE ABILITY OF A SPECIALIST AS DEALER TO TAKE ADVANTAGE OF KNOWLEDGE OF ORDERS ON HIS BOOK TO THE DETRIMENT OF EITHER HIS CUSTOMERS OR THE MARKET AS A WHOLE.

THE SPECIAL STUDY'S RECOMMENDATION THAT SPECIALIST FIRMS BE PROHIBITED FROM HANDLING ORDERS IN THEIR SPECIALTY STOCKS PLACED BY THEIR OWN PUBLIC CUSTOMERS WAS NOT INCORPORATED IN THE COMMISSION'S RULE 11B-1. NOR HAS ANY EXCHANGE IMPOSED SUCH A RESTRICTION. BOTH THE NEW YORK AND AMERICAN STOCK EXCHANGES DO HAVE RULES, HOWEVER, WHICH ADDRESS SIMILAR CONCERNS. THUS, ON THOSE EXCHANGES SPECIALISTS ARE PROHIBITED FROM ACCEPTING ORDERS IN THEIR SPECIALITY STOCKS DIRECTLY FROM COMPANIES IN WHOSE STOCKS THEY SPECIALIZE, OR FROM ANY OFFICER, DIRECTOR OR 10 PERCENT SHAREHOLDER OF SUCH COMPANIES, OR FROM CERTAIN INSTITUTIONAL INVESTORS.

BEFORE I TURN TO THE PLACE OF THE QUALIFIED SPECIALIST IN THE NATIONAL MARKET SYSTEM, I WILL BRIEFLY DISCUSS OUR SECOND MODEL FOR THE RESOLUTION OF BROKER AND DEALER CONFLICTS OF INTEREST -- OVER-THE-COUNTER MARKET-MAKERS. BECAUSE THEIR CONFLICTS OF INTEREST HAVE BEEN RESOLVED BY AD HOC ADJUDICATION, THE STANDARDS WHICH HAVE EVOLVED FOR THE OVER-THE-COUNTER MARKET-MAKER ARE LESS COMPREHENSIVE AND LESS ELABORATE THAN THOSE APPLICABLE TO EXCHANGE SPECIALISTS.

CERTAINLY, THE BASIC FIDUCIARY OBLIGATIONS OF AN AGENT HAVE BEEN RECOGNIZED AND GIVEN FORCE. IN OPPER V. HANCOCK, 250 F. SUPP. 668 (S.D.N.Y.), AFF'D. 367 F. 2D 157 (2D CIR. 1966), FOR EXAMPLE, THE SECOND CIRCUIT MADE CLEAR THAT A BROKER-DEALER IN THE OVER-THE-COUNTER MARKET, ONCE HAVING ACCEPTED A CUSTOMER'S ORDER AS AGENT, CANNOT THEN COMPETE WITH HIS CUSTOMER IN SEEKING AN EXECUTION FOR HIS OWN ACCOUNT.

THE GENERAL DUTY OWED BY EVERY BROKER-DEALER TO DEAL FAIRLY WITH THE PUBLIC -- THE SO-CALLED "SHINGLE THEORY" -- HAS BEEN HELD TO IMPOSE UPON A DEALER THE DUTY TO TRADE WITH HIS CUSTOMERS ONLY AT PRICES REASONABLY RELATED TO THE CURRENT MARKET PRICE AND TO AVOID EXCESSIVE MARK-UPS OR MARK-DOWNS. (CHARLES HUGHES & CO., INC. V. SEC, 139 F. 2D 434 (2D CIR. 1943)). THIS STANDARD, OF COURSE, HAS BEEN CODIFIED IN THE "MARK-UP POLICY" OF THE NASD. ALSO, A BROKER-DEALER IN WHOM A CUSTOMER HAS REPOSED TRUST AND CONFIDENCE MUST DISCLOSE, IN ADDITION TO THE CAPACITY IN WHICH HE IS ACTING, ANY ADVERSE INTEREST WHICH HE MAY HAVE IN TRANSACTIONS. (ARLEEN W. HUGHES V. SEC, 174 F. 2D 969 (D.C. 1949)).

IN ADDITION, THE DISCLOSURE REQUIREMENTS OF THE SECURITIES LAWS HAVE BEEN APPLIED TO THE BROKER-DEALER CONFLICT. THUS, FULL DISCLOSURE IS REQUIRED WHERE A BROKER-DEALER EXERCISES EFFECTIVE CONTROL OVER THE MARKET PRICE OF A SECURITY IN WHICH

HE DEALS WITH HIS CUSTOMER (Norris & Hirshberg, Inc. v. SEC, 177 F. 2d. 228, (D.C. Cir. 1949)). Moreover, a firm which recommends a security to a customer, must disclose its activities as a market-maker in that security. (Chasins, Smith Barney & Co., Inc. 438 F. 2d 1167, (2d Cir. 1970)).

In the over-the-counter market, market-makers have not been subject to requirements imposing negative or affirmative obligations to maintain a fair and orderly market, or to restrictions on the types of customers from whom they may directly accept orders in the securities in which they make markets. Even market-makers using the NASDAQ System are not currently subject to any affirmative obligations comparable to those imposed upon the New York or American Exchange specialist. NASD rules require that quotations entered by NASDAQ market-makers must be "reasonably related to the prevailing market." A market-maker who enters "unreasonable" quotations, or who withdraws his quotation and later enters quotations in the same security during the same day without prior approval of NASDAQ, is subject to disciplinary sanction.

A third model for the qualified specialist is the CBOE, where segregation in large measure exists. The agency function is assigned to a single specialist-broker, called a "board broker" and the dealer function is the responsibility

OF A LARGE GROUP OF SPECIALIST DEALERS THAT ACT AS COMPETING MARKET-MAKERS. IN ADDITION, CERTAIN MARKET-MAKER OBLIGATIONS APPLY WHICH REQUIRE THE QUOTING OF A TWO-SIDED MARKET IN APPOINTED OPTION CLASSES. THE PACIFIC AND MIDWEST STOCK EXCHANGES ALSO HAVE SEGREGATED THE BROKER AND DEALER FUNCTIONS IN OPTIONS TRADING.

I KNOW YOU HAVE ALL BEEN WAITING FOR ME TO TURN TO A DISCUSSION OF HOW BROKER-DEALER CONFLICTS OF INTEREST WILL BE RESOLVED IN THE NATIONAL MARKET SYSTEM. AS ALL OF YOU ARE WELL AWARE, IN JANUARY THE SEC ISSUED A POLICY STATEMENT SETTING FORTH ITS VIEWS ON IMPLEMENTATION OF THE NATIONAL MARKET SYSTEM. IN THAT STATEMENT, THE COMMISSION ATTEMPTED TO WALK A MIDDLE GROUND BETWEEN PROPONENTS OF A MODIFIED PRIMARY EXCHANGE MARKET AND PROPONENTS OF AN ELECTRONIC MARKET SYSTEM IN WHICH ALL ORDERS WOULD BE ENTERED INTO A COMPUTER-BASED SYSTEM AND WOULD BE EXECUTED AUTOMATICALLY IN THAT SYSTEM. ONE REASON THE COMMISSION REJECTED THE ELECTRONIC NATIONAL BOOK WITH AUTOMATIC EXECUTION, OR SO-CALLED "BLACK BOX" SOLUTION, AS A MODEL FOR THE NATIONAL MARKET SYSTEM WAS OUR SERIOUS CONCERN ABOUT THE BROKER-DEALER CONFLICTS OF INTEREST WHICH COULD SURFACE IN SUCH A SYSTEM.

DURING THE PERIOD FROM THE SEC'S JUNE 1977 RELEASE PROPOSING THE ABOLITION OF ALL OFF-BOARD TRADING RESTRICTIONS AND OUR JANUARY 1978 POLICY STATEMENT, I LISTENED TO MUCH PUBLIC AND PRIVATE DEBATE ABOUT THE EVILS WHICH WOULD RESULT IF THE GIANT WIRE HOUSES COMMENCED MARKET-MAKING IN LISTED SECURITIES AND IN SO DOING INTERNALIZED THEIR RETAIL ORDER FLOW. AS I WRESTLED WITH THE PROBLEMS UNDER DISCUSSION IT SEEMED TO ME THAT THESE WERE THE VERY SAME PROBLEMS THE SEC WAS DIRECTED TO CONSIDER IN OUR 1936 SEGREGATION REPORT, AND THAT WE SHOULD DEAL WITH THEM IN 1978 IN THE SAME MEASURED AND REASONABLE WAY. IT IS MY PERSONAL VIEW THAT SERIOUS CONFLICTS OF INTEREST WOULD EMERGE IF AUCTION TRADING IN THE EQUITY SECURITIES OF OUR LARGE PUBLIC CORPORATIONS BY REGULATED SPECIALISTS WERE TO DISAPPEAR. FURTHER, I DO NOT BELIEVE THAT SUCH CONFLICTS OF INTEREST COULD BE SOLVED EXCEPT BY COMPLETE OR PARTIAL BROKER-DEALER SEGREGATION. I HEAR MUCH TALK ABOUT THE NEED TO UTILIZE THE CAPITAL OF THE PUBLIC BROKER-DEALERS IN THE MARKET-MAKING FUNCTION. BUT SUCH UTILIZATION, PARTICULARLY IF COMBINED WITH THE ELIMINATION OF RESTRICTIONS ON SPECIALIST'S COMMUNICATIONS WITH INSTITUTIONS AND INSIDERS, RAISES A HOST OF THE SAME KIND OF CONFLICT OF INTEREST PROBLEMS WHICH LED TO THE PASSAGE OF THE INVESTMENT COMPANY ACT OF 1940.

DESPITE MY VIEW THAT THE EXCHANGE SPECIALIST, APPROPRIATELY REGULATED, PERFORMS A VALUABLE MARKET FUNCTION, I DO NOT BELIEVE THAT THE PRESENT UNITARY SPECIALIST SYSTEM WHICH EXISTS AT THE NYSE OR THE AMEX IS SACROSANCT OR BEYOND IMPROVEMENT. THE UNITARY SPECIALIST SYSTEM TODAY IS, FOR ALL INTENTS AND PURPOSES, A MONOPOLY. AT LEAST SOME OF THE IMPETUS FOR LEGISLATIVE AND REGULATORY REFORM OF OUR MARKET SYSTEM AND DEMANDS FOR GREATER COMPETITION IN MARKET-MAKING HAS BEEN FRUSTRATION OVER REFORMING THE UNITARY SPECIALIST SYSTEM.

THE IMPLEMENTATION OF THE INITIATIVES SET FORTH IN THE SEC'S JANUARY STATEMENT COULD SIGNIFICANTLY ALTER THE DYNAMICS OF THE SPECIALIST SYSTEMS. HOWEVER, NO MATTER HOW THE PRESENT SPECIALIST SYSTEMS ARE RESTRUCTURED IN OUR NATIONAL MARKET SYSTEM, THE CONFLICTS OF INTEREST OF THE QUALIFIED SPECIALIST MUST BE RESOLVED IN A MANNER NO LESS SATISFACTORY THAN THE WAY THESE CONFLICTS ARE PRESENTLY RESOLVED. IF SUCH A RESOLUTION CANNOT BE ATTAINED BY SIMILAR REGULATION OF THE QUALIFIED SPECIALIST, I SEE NO WAY TO APPROPRIATELY RESOLVE THESE CONFLICTS OTHER THAN BY COMPLETE OR PARTIAL SEGREGATION OF THE BROKER AND DEALER FUNCTIONS. IN MY MIND, THIS IS AS GREAT A CHALLENGE TO THE INDUSTRY IN RESPONDING TO THE COMMISSION'S JANUARY STATEMENT AS ANY OTHER CHALLENGE FACING ALL OF US IN DEVELOPING A NATIONAL MARKET SYSTEM.

ONE OF THE PROPOSALS IN THE SEC'S JANUARY STATEMENT WHICH COULD PROVE ESPECIALLY DIFFICULT TO INTEGRATE WITH THE CURRENT SPECIALIST SYSTEM IS THE CENTRAL FILE. IN OUR JANUARY POLICY STATEMENT, THE CENTRAL FILE IS VIEWED AS A MECHANISM IN WHICH PUBLIC LIMIT ORDERS MAY BE ENTERED FOR EXECUTION IN ACCORDANCE WITH AUCTION TRADING PRIORITY PRINCIPLES.

THE SEC RELEASE VERY CLEARLY STATES THAT THE COMMISSION'S DETERMINATION TO PROCEED WITH DEVELOPMENT OF A CENTRAL FILE SHOULD NOT BE "INTERPRETED AS A DECISION TO FORCE ALL AUCTION TRADING INTO AN ELECTRONIC SYSTEM WITH AUTOMATIC EXECUTION CAPABILITIES". THERE SEEMS TO BE WIDESPREAD DOUBT OVER THE COMMISSION'S SINCERITY IN MAKING THAT STATEMENT. HOWEVER, I SINCERELY BELIEVE THAT CURRENT SPECIALIST SYSTEMS ARE COMPATIBLE WITH, AND CAN SURVIVE, THE CENTRAL FILE.

OBVIOUSLY, THE CENTRAL FILE POSES SERIOUS CHALLENGES TO THE SPECIALIST AND THE EXCHANGES. THE CBOE COULD PROBABLY CLAIM THAT ITS BOARD BROKER'S BOOK IS A MODEL OF A CENTRAL FILE FOR THAT EXCHANGE. IF A MARKET-MAKER IN QUALIFIED SECURITIES MUST CLEAR A CENTRAL FILE, THAT CONCEPT POSES CHALLENGES TO THE OVER-THE-COUNTER MARKET-MAKER AS WELL. BUT IF THESE CHALLENGES ARE MET HONESTLY AND CONSTRUCTIVELY, THE INVESTING PUBLIC, WHICH AFTER ALL FINANCES THE TRADING MARKETS, WILL BENEFIT.

AMONG THE SPECIFIC MAJOR PROBLEMS WHICH THE SECURITIES INDUSTRY WILL HAVE TO FACE IN CONSTRUCTING A WORKABLE CENTRAL FILE ARE: (1) HOW CAN ORDERS BE ENTERED IN THE FILE AND BY WHOM; (2) WHAT KIND OF ORDERS SHOULD BE CONSIDERED "PUBLIC" AND APPROPRIATE FOR INCLUSION IN THE FILE; (3) HOW WILL QUALIFIED SPECIALISTS INTERACT WITH THE FILE AND HOW WILL LIMIT ORDERS IN THE FILE BE EXECUTED; (4) WHAT TYPE OF PRIORITY SHOULD ORDERS IN THE FILE ENJOY; (5) HOW SHOULD THE FILE BE FINANCED; (6) IF THE EXCHANGE SPECIALIST LOSES SOME OR ALL OF HIS BROKERAGE INCOME AS A RESULT OF THE FILE CAN HE BE EXPECTED TO COMPORT WITH THE AFFIRMATIVE AND NEGATIVE OBLIGATIONS HE NOW HAS UNDER THE RULES OF THE NYSE AND THE AMEX, OR SHOULD HE BE FREE TO OPERATE IN THE SAME UNRESTRICTED MANNER AS OVER-THE-COUNTER MARKET MAKERS; AND FINALLY (7) HOW ARE CONFLICTS OF INTEREST TO BE RESOLVED?

IT IS TEMPTING TO ANSWER THESE QUESTIONS IN PIOUS GENERALITIES, BUT I WILL RESIST THAT TEMPTATION. IF ONE OF THE OBJECTIVES OF A NATIONAL MARKET SYSTEM IS INCREASED COMPETITION IN MARKET-MAKING, AND I BELIEVE IT IS, SUCH COMPETITION WILL REQUIRE THE DEDICATION OF INCREASED CAPITAL TO THE MARKET-MAKING FUNCTION. AND CAPITAL WILL NOT FLOW INTO MARKET-MAKING UNLESS MARKET-MAKING IS PROFITABLE.

THE GOVERNMENT OBTAINS ITS REVENUES FROM TAX DOLLARS; IT IS NOT A PROFIT MAKING OPERATION. I DO NOT THINK THE SECURITIES INDUSTRY CAN LOOK TO THE GOVERNMENT FOR IDEAS ON HOW TO MAKE THE NATIONAL MARKET SYSTEM ECONOMICALLY VIABLE. THE SECURITIES INDUSTRY MUST APPLY ITS INVENTIVE TALENTS TO MAKING COMPONENTS OF THE NATIONAL MARKET SYSTEM SUCH AS THE CENTRAL FILE ECONOMICALLY ATTRACTIVE TO PARTICIPANTS AND USERS, AND THEN PERSUADE A SKEPTICAL PUBLIC THAT ITS SOLUTIONS ARE RESPONSIBLE. THE SECURITIES INDUSTRY AND THE SEC MUST NOT FORGET THAT OUR PRIMARY MUTUAL OBJECTIVE IS A SECONDARY TRADING MARKET OF SUFFICIENT EXCELLENCE TO WARRANT INVESTOR CONFIDENCE, AND TO GIVE INVESTORS THE INCENTIVE TO PURCHASE SECURITIES WITH THEIR CAPITAL SAVINGS.

I BEGAN THIS SPEECH ON A PERSONAL NOTE, TALKING ABOUT THE IMPORTANCE OF THE INDIVIDUAL IN A COMMUNITY WHOSE MOTTO IS "OUR WORD IS OUR BOND." ON WALL STREET, MILLIONS OF DOLLARS CHANGE HANDS ON PERSONAL TRUST EACH DAY. THAT TRUST EXISTS BECAUSE THE EXCHANGES AND THE NASD ARE ECONOMIC, POLITICAL AND SOCIAL INSTITUTIONS WHICH BIND A DISPARATE INDUSTRY TOGETHER. THE NATIONAL MARKET SYSTEM MUST FUSE, AND NOT LOSE, THE SENSE OF COMMUNITY WHICH EXISTS IN THOSE INSTITUTIONS. I BELIEVE THAT ALL OF US IN THE 1970'S HAVE COME TO APPRECIATE

THE LIMITATIONS OF TECHNOLOGY IN SOLVING OUR NATIONAL PROBLEMS. PERHAPS AS THE DECADE PROGRESSES WE WILL ALSO LEARN THE LIMITATIONS OF REGULATION IN SOLVING THOSE PROBLEMS.

WHAT WE DO NEED, ESPECIALLY IN THE SECURITIES INDUSTRY, IS LEADERSHIP. AS YOU RESPOND TO OUR JANUARY POLICY STATEMENT, I HOPE YOU WILL CONSIDER AND MEET THE REAL NEED OF THE MARKETPLACE -- TO PROVIDE AN EFFICIENT AND TRUSTWORTHY MECHANISM FOR FAIR AND ORDERLY MARKETS IN WHICH DEALER AND INSTITUTIONAL INTERESTS ARE NOT PREFERRED OVER THE INDIVIDUAL INVESTOR.