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NEW CHALLENGES FOR THE SECURITIES INDUSTRY

An Address By

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THE INVESTMENT ASSOCIATION
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Mr. Chairman, Ladies and Gentlemen. One of the hazards of my present job, I have discovered, is the temptation to accept speaking engagements both too soon and too close together. When I used to watch my predecessors from my comfortable quarters in Chicago, I made a resolve with respect to each one of them that if I ever became Chairman of the SEC, I would not be running around talking so much -- especially before I had anything to say. Resistance to pleasant temptation, however, is not one of my stronger traits, and I find that I am as guilty as the rest of them.

It isn't just the temptation to talk too much that is dangerous. It is also the temptation to make news either through some profound policy statement or something exciting. Both of these are rather easy to do if you do not care too much about the results. With a little effort I think I can be profound once a week but to do so without being repetitive, would result in enormous confusion. It is even easier to be newsworthy by being exciting, such as through saying something very careless or stupid. So although headlines are fun, I try to avoid either too much profundity or too much carelessness.

The things I have to say tonight may not strike you as newsworthy on either ground, but I do think there are some interesting things for us to be talking about.

I am told, and I can observe, that this group is somewhat younger than other collections of industry leadership, and it seems like an appropriate time to talk about the future. One of your number recently observed to me that in the securities industry short-range planning is worrying about this afternoon and long-range planning is when you worry about tomorrow or the next day. However true this might once have been, it seems clear to me that it is not true at all today. I see much evidence of long-range, constructive thought and planning, and that is what I would like to talk about.

Last September 11th, at the same time that we revealed our non-objection to the New York Stock Exchange's proposed increase in fixed minimum commission rates, we stated that we proposed to take whatever administrative action should be necessary to cause the fixed minimum commission rate system to be eliminated by April 30, 1975, with an interim step to be effected after March 31, 1974. I strongly suspect that most of the instant rejoicing at that time was directed

toward the unconditional increase permitted for six months with somewhat lesser attention paid to what we proposed should follow. In the spirit of that time, and to some extent even of the present, it was wholly natural that members of the securities industry should rejoice at the prospect of immediate increased revenues while postponing worry about the drastic changes that will come later. It has also led to speculation that we didn't really mean it, or if we did, could probably be talked into changing our minds before anything too terrible happened.

In our mind, we are not proposing to do to the exchange community anything that would not be done to it one way or the other by somebody or other, probably in a less desirable fashion. But whether you believe that or not, our purpose was to stop arguing about what seems to be inevitable in the present structure of the industry and to start the countdown, hopefully stimulating constructive thinking rather than romantic fantasy. There is good evidence that such thinking has already begun, but only begun because I think that a realistic vision of an unfixed world comes rather slowly to most of you that have spent so many years in another system.

For example, we get questions as to whether, when commissions have come unfixed, a given firm will be permitted to post different rates in different parts of the country. That sort of question indicates the fundamental misconception. Our proposal is to take the Commission and the Exchanges out of the rate fixing business. When we are both out of the rate fixing business, individual firms will be able to post any rates that they can sustain under the antitrust laws. I suggest that many of you had better start spending more time with the antitrust partners in the firms that give you legal counsel. You will be faced with the same sort of problems that confront other companies that market a product on a wide scale in close competition. It will be necessary to avoid both the reality and the appearance of so-called predatory pricing, and you will have to discover through experience with the free effect of competitive forces whether your industry can live with price competition, that is to say, whether one large firm can long

sustain a price schedule that is substantially different from that of its most immediate competitor. You will have to learn whether different types of clientele and different combinations of services will sustain different price levels. You will also have to decide to what extent your own commission rates are to be negotiable. It has been a confusing misuse of terms to refer to unfixed commissions as negotiated commissions. This term made sense when fixed commissions were removed only for orders above $500,000 and then above $300,000, but it is wrong to use the term negotiated to refer to all commissions in an unfixed universe.

I cannot imagine, for example, that any firm with many branch offices would permit registered representatives or even branch managers to negotiate commissions on a 100 share trade if only because of the madness that this would create for the poor computers. On the other hand, I suppose that somewhere in the total pricing structure there will be a negotiable area, with authority to negotiate delegated to a certain person or certain persons. Whether the negotiable area will be designated entirely in terms of dollar magnitude

of the order or on the nature of the customer and the services used by that customer -- and whether the latter basis for designation will stand up under the anti-trust laws -- is something that you will have to discover.

That is the kind of discussion and thinking that is going to be fruitful for you in planning for the unfixed world of 1975. But there is more than just that to prepare oneself for that dread date. Some commentators have stated that the removal of fixed commissions on April 30, 1975 will mean the death of the securities industry as we know it. Such a statement obscures the fact that the industry as we have known it is dying anyway in the sense that radical changes are taking place and cannot be stopped. They can only be brought about in a constructive way. In this sense, we have not said that on a specific date eighteen months from now there should be a securities industry exactly as we have it now except operating without the fixed commission rate umbrella. The Commission's decision to end fixed rates is based on a number of facts, not the least of which is the realization that the markets of the future, no matter what we do in the rate area, will surely be radically different by 1975. Tonight I would like to explore with you some of the ways in which we

see the market becoming different. And I should add that it is becoming different not just because of governmental action, whether administrative or legislative or judicial, but because of changes in the technology available for the conduct of business, changes in both the domestic and world markets related to securities and money, and increasingly imaginative thinking on the part of many members of the industry itself.

The direction of the cumulative changes is usually referred to as a central market system. It is easy today to get agreement among industry leaders that we are headed toward such a thing. There is difficulty, however, in getting agreement as to what its components will be, how we should get there, and particularly, which component should come first on the priority scale.

Let me suggest what I believe is generally agreed to be the components of the central market system and then spend a few minutes talking about some of the obvious areas of disagreement.

I think it is generally agreed that a sound central market system will involve multiple market-makers in different market centers of the country, all in electronic communication

so that there will be a composite tape reporting on a real-time basis and in proper sequence all transactions in securities covered by the system, and a quotation system which will provide all members of the system with current information at any given moment as to the state of the bid and ask in several markets. It will be supported by a nationwide depository system with regional clearing and regional depositories in major financial cities. It will also provide all members of the system with access to efficient back office facilities, either on a single nationwide basis or by means of cooperative or contract back office services. The availability of such facilities should reduce, if not eliminate, the cost efficiency differential among all broker-dealer firms, large and small. This is a desirable feature if smaller firms are to remain competitive in a universe of unfixed commission rates. Such a central market system will take maximum advantage of available modern technology to provide liquidity and continuity and depth on a broader scale than we have ever known before. In the course of time it should be compatible with an international system that will link together all of the securities markets of the free world.

Now where are the disagreements in achieving this shining goal? Let us start first with the disagreements about some characteristics of the system. In its White Paper of last March on the Central Market System, the Commission viewed the central market system as including all of the registered national securities exchanges plus so-called third market firms. The third market firms would be members of the system, and pay certain user charges for that status, but would not be required to become members of any securities exchange. We thus envisioned competition through the central market system between the specialists on the several primary and regional securities exchanges and the third market-makers. This has led to serious disagreement with the New York Stock Exchange.

One reason is that we have not agreed that third market market-makers in the central market system should be denied the ability to deal directly with institutional purchasers. You will recall that for some years now the specialists on the New York Stock Exchange have been forbidden -- by Rule 113 -- to take orders directly from institutional customers. They can only take such orders from other member firms. The New York Stock Exchange wants equal treatment for specialists and third

market market-makers if they are to share in the central market system. They argue that unless this occurs the central market system might soon degenerate into a dealer market, over-the-counter style, rather than the auction market as we have known it on the exchange. They further argue that if Rule 113 were eliminated some major firms have stated that membership on the NYSE would no longer be interesting to them and they would go "upstairs" to become third market makers themselves. Thus their suggested solution is to apply Rule 113 to all market makers competing in the system.

The Commission, on the other hand, has expressed the view that the need for such rules is much less apparent in a system of competing market makers without a dominant specialist, and it has suggested the possibility that the rules be repealed when the regulatory need that prompted their adoption ceases to exist. We have also pointed out our difficulty in agreeing to a determination that requires an institutional customer to utilize the services of a broker whether or not in his judgment he needs such services. In fact, we wonder whether such rules would have any effect under a system of competitive

rates, which would permit easy circumvention of the prohibition by permitting an investor to negotiate directly with a market maker and then paying a nominal commission to a broker for nominally participating in the trade. Regardless of what you think of these arguments, I think you can agree with me that the debate has not ended.

The ongoing debate has also involved questions of priority. For example, the view has frequently been expressed that prior to implementation of the composite tape it would be desirable, if not essential, that a set of equal or at least comparable rules be applied to all markets that will be reporting on the tape. We have not been insensitive to these views and in fact have stated that it may well be possible for a good many of these regulations to be fashioned before the tape commences operation, although we have not agreed that these regulations are an essential prerequisite to such operation. The New York Stock Exchange has taken a constructive step by preparing a document which sets forth the major areas in which it believes greater uniformity among market centers must be imposed. This paper is a useful check list and can help expedite our work in coordinating the

formulation of appropriate rules for all market centers in the system. In this area, too, we look forward to continuing give and take.

Meanwhile, there are exciting developments in the area of processing securities both in clearance and in depository arrangements. It is not too much to hope that within perhaps a year there will actually be in existence such a national clearing system based upon the National Clearing Corporation of the NASD and the Stock Clearing Corporations of the several exchanges, including the arrangements recently announced by the Securities Industry Automation Corporation.

There are of course even more imaginative persons some of whom have published their ideas and who should be well known to you, who think that even this concept of a central market system is too shortsighted. They imagine, in addition to centralization and unification of the mechanical facilities for trading and clearing in securities, a reduction in the number of governmental and self-regulatory bodies having responsibility for supervision of the securities industry. It has been suggested by responsible people, for example, that a new entity of a quasi-official sort should be created, to take

over the functions of SIPC, NASD, the various securities exchanges and all of the stock clearing and depository arrangements plus the market regulation activities of the SEC, all in a single package -- resembling various aspects of the Federal Reserve Board, the FDIC, our present SIPC and COMSAT, as well as the NASD.

Some of these ideas are designed, or would at least result, in the restructuring of the securities industry in a fashion that might provide a sound basis for a so-called public utility approach to the securities industry and its rate structure. I do not know whether many of you would really prefer to be engaged in a true public utility-type industry if given a choice. It would require among other things that the components of the industry be sufficiently concentrated in brokerage activity as to facilities and expenses and revenues so that a reasonable approach can be made to estimates of revenues necessary to cover costs plus reasonable return on capital. This is certainly not true of the industry today. Such a system could never resemble our electric or gas utility rate making, where a different rate is established

for each company in the industry. It would probably more closely resemble telephone, airline or railroad rate making, and I don't know whether contemplating this fills you with real enthusiasm for the idea or not.

A recent proposal, wherein a Federal Reserve-type supervisory authority could be set up to govern the execution function alone, leaving the rest of the services provided by brokers to be compensated on an annual flat fee basis, also has stimulated interest. Although this has the advantage of removing the conflicts, actual and psychological, of the system of compensation by transaction, it still leaves the problem of allocation of costs and reasonable return.

This flow of ideas is healthy and necessary if the industry is to thrive and prosper. We are not willing to reject any of these suggestions without carefully considering whether they offer the prospect of a meaningful and appropriate structural overhaul of the securities business. Almost without exception, I have been confronted with the question whether our receptivity to these theories means the Commission is less than completely committed to our conclusion that fixed rates must fade away on April 30, 1975. My answer is no.
Our conclusions concerning an appropriate framework for the

elimination of fixed commission rates, however, were developed in the context of the structure of our securities markets prevailing today. Factors such as individual member firm profitability, or lack thereof, will not prove a persuasive argument for those seeking to have us abandon or delay the clearly-defined course toward competitively-determined commission rates we have charted. On the other hand, it is not inconceivable that if a major alteration in the industry's structure, if palatable to all concerned, including the Congress, can be found -- as opposed to mere changes in member firm profitability -- our conclusion on fixed rates might warrant another look. Of course, such a restructuring would necessarily involve architectural revamping far more drastic than our present working blueprint for a central market system.

The important thing to bear in mind is that it is a time of exciting change and challenge for the securities industry in the United States. I would urge you to look upon the future in that spirit and to accept the fact that the SEC is not out to destroy the securities industry. It has in the past and may well in the future thought it necessary to cajole, needle, and even push and shove various components of the industry toward a

realization of what the future must bring. This is not done because we have thought or do think or will think that the securities industry of the United States is a collection of evil people to be harrassed and punished. While enforcement and punishment is an unavoidable part of our duty, our total objective, and yours, is the public interest and the interest of investors of the United States. The maintenance of our capital system, the preservation and encouragement of growth through the access of new and smaller companies to reasonable equity markets are all essential to that public interest and the interest of investors. It pleases me greatly to become familiar with the ever growing hard thinking and work in planning that your industry is providing for itself and for the public interest in these times. I urge all of you to shake off any feelings of oppression or doom and get caught up in the excitment of what we are on the threshhold of achieving.