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THE SECURITIES INDUSTRY: A LOOK AHEAD

An Address By

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I suppose that at the first annual meeting of the former Investment Bankers Association there was much talk about the many threats to the free enterprise system in general and the continued prosperity of investment bankers in particular. When the old IBA joined with the Association of Stock Exchange Firms, it became possible, as well, to talk about the threats to broker-dealers. Since most investment bankers are also broker-dealers, the merger made it possible to deplore everything at the same time.

Since it is the penchant of every industry group, when assembled at annual convention, to indulge in mass paranoia, even when its members are shamelessly profitable, it is tempting to pass off the fears of today as manifestations of a chronic emotional state not to be taken too seriously. I wish I could honestly take such a philosophical, indeed cavalier, attitude toward the troubles that beset you, and therefore the Commission as well. I haven't bothered to go back and examine what speakers at this meeting were viewing with alarm in years past when young registered representatives were pulling down a $100 thousand or more. It really doesn't matter. Maybe

I would discover that some were prescient enough to have foreseen some of our present concern.

Whether they were or not, many of the fears and uncertainties that beset members of the securities industry today, as far as I am concerned, are genuine. Whatever may have been the case a decade or so ago, today, any member of this industry who is not worried about the industry belongs on a happy farm. The industry's problems are real and critical. And because of the central role played by the securities industry in our economy, your problems -- collectively if not individually -- are problems for our entire economy and, therefore, for our society and our political system.

There is no doubt that free and efficient capital markets are essential to a free economy. And, at least in my mind, there is no doubt that a free economy is essential to a free society and constitutional government. Once entrepreneurs have to look solely to the government for capital, economic freedom is gone. And once economic freedom is gone, political freedom will not be far behind. It is very clear to me that in worrying about the present state of our securities industry, we are also worrying about our free economy and our free society. If, ten years from now, someone like me should stand here and disparagingly proclaim that those fellows in 1973 were worrying for nothing, I will not be ashamed. If I am around, I will say Hallelujah.

What are we worried about? Individually, you are entitled to bemoan the fact that almost all of you have had a rotten year financially, and to worry about whether you will be able to see your way clear to reasonable profitability in the years to come. On top of the more familiar uncertainties about the state of the market, trading volume, costs, et cetera, you now are faced with a rather onerous uncertainty about the rules of the game in which you will play and whether you can survive individually under the rules that are shaping up, even if the industry generally prospers.

This is a sufficiently fearful state in ordinary times -- if there ever are any ordinary times. I suppose times never seem ordinary while we are in them. Whatever may have seemed extraordinary in the ordinary times of the past, what is extraordinary right now is the combination of the disarray of our securities markets and securities industry at a time when we face enormous forthcoming demands for capital, not just for new industries but also, and even more, for basic industries -- public utilities and other companies engaged in what we now call energy.

There are elements in the energy crisis -- which even the worst cynics now seem to accept as real -- that present a unique threat to our society. The fact that we may have to give up Sunday drives and wear long underwear is comparatively trivial. The real danger of the energy crisis is not the prospect of some discomfort in our personal lives, it is the horrible strain it could place upon our political and social structure. We are not in very good shape to suffer a substantial increase in unemployment. Still less are we in very good shape to engage in an orderly process of allocation of energy uses. It is much too late to say that rich men can have air conditioning but poor men can't, or to say that residents of the Southwest must give up electric energy so that Northern city dwellers can heat their houses, and expect quiet acceptance from persons thus deprived.

Any alleviation of the energy crisis, even if oil from the Middle East becomes available shortly, will require hundreds of millions of dollars of new capital over the coming decade. In the face of this demand for its services, the securities industry is less than combat ready. At a time when its role in the formation of capital appears to be more critical than at any time one can recall, the securities industry is in a state of confusion and bickering, with morale low.

What brought about this unfortunate condition? The question is probably not worth exploring except as the answer might provide guidance for the future. Some of you, however, are no doubt thinking, if not saying, that it is all the Commission's fault.

Take, for example, the question of fixed commission rates. It has been urged by some that our policies in this area will hamper, not foster, the appropriate channeling of investor dollars into critical industries because revenues will not be available to support investment research services. But this conclusion is far too dismal; consumers and investors on this country have always been willing to pay for valuable services. In fairness, there is no reason to suspect a change in this regard. It may be true, of course, that investors will no longer be willing to support superfluous research of a reportorial nature, but they clearly will continue to demand those services performed by truly professional securities analysts and be willing to pay for them.

In a similar vein, some industry observers apparently believe that the network of well-established regional securities dealers, on which the syndication of many primary offerings is dependent, may be threatened by the advent of unfixed commissions. They argue that many regional firms may disappear because the lack of fixed rates necessarily will mean a diminution in the income these firms can earn.

This is a problem in which you have a very direct concern and, obviously, we share your concern with the preservation of this important regional service. But I seriously question whether an end to fixed rates must entail a lessening of profits. Efficiency, imaginative services and the spur of competition should preclude such a result. Among other things, the removal of fixed commissions should enable regional as well as other firms to charge higher rates for services that warrant such charges.

Nevertheless, some of you still may be saying that, if the Commission had only left things alone, everything would still be all right. Even if this were true, this thinking does not lead to constructive action. But I don't think it is true. I am not going to pretend that everything the Commission has done relating to market structure over the last ten years was the product of perfect wisdom and foresight. That would be silly.

There is, however, one episode that is worth mentioning. Eight years ago, the then Chairman, Manny Cohen, spoke to this meeting -- then of the Investment Bankers Association -- and lectured you about commission rates and the desirability of the exchange community working with the Commission to develop a more rational and defensible rate structure. Some of your number have expressed the thought that all of your present miseries began at that moment. This reaction has surprised me, because I remember reading Mr. Cohen's speech in those days and thinking he was obviously saying, in effect, that if you want to preserve a fixed rate structure in the face of possible challenges under the antitrust laws, you had better cooperate in producing something sensible that will stand up. I don't know what would have happened if it had worked out that way, but it didn't.

I only mention this to encourage you to keep in mind that there are federal antitrust, as well as federal securities, laws. And even your present travail is perhaps not so bad as treble damage liability -- assuming this has been avoided -- and market structure determined by decrees of a federal district court.

As to the future, how do we stand? Looking beyond individual problems, how will we structure our capital markets and securities industry to meet the urgent demands of the future, both near and far?

The one way in which it cannot be done is to try to recreate the happy world of the past. I realize that we had a pretty good thing going when I first got involved in this field, as a lawyer, over twenty years ago. A lot of people were making good money -- though certainly not the younger lawyers -- and it worked pretty well. And nostalgia is fashionable these days. Well, you may be able to make money on nostalgia today in the popular arts, but you are not going to make any money on it in the securities industry. Attempts to revert back to the thrills of yesteryear will prove to no avail. It is technologically absurd and socially and politically impossible to go backwards. There is only one way to go, and those who cannot adjust to the future, for whatever reason, will have to drop out. Those are harsh words; but, then, these are harsh times.

I think it would help if I get more specific and address myself to some of the concrete points of dispute, especially differences between the official views of your Association and those of the Commission. Let me start with a relatively easy matter and work up.

In November, 1972, the Commission adopted a rule, Securities Exchange Act Rule 17a-15, directing the establishment of a consolidated tape. Ever since, we have been in an argument over whether the tape should start in operation, which has been our view, even though all problems of equal regulation and national clearing have not been worked out. Indeed, we have thought that many regulatory problems could better be resolved after observing the tape in operation for a period, and we have been concerned that prolonged bickering over rules could cause the indefinite delay of the tape. After all, the tape was, in many respects, a response to the complaint that much trading off the primary exchanges took place in secret, while the primary exchanges, with their widely-distributed tickers, were living a far more candid and open existence.

In my opinion we are going to work this thing out. This just has to be so, in large measure because industry representatives helped design the tape. It is also true because the industry needs the tape, and the industry will have the tape if it can just work together.

Contrary to what you may sometimes feel, we do not really think that we are omnipotent. We have a fairly clear realization of our pragmatic limitations. We know we cannot simply raise our hand and proclaim "Let there be a consolidated tape." Of course, we can proclaim it, but since it is your industry that has to do it, it will be much better if we can effect the tape cooperatively, as I believe we will, without the need for true compulsion. We do intend to use all of our resources to maintain pressure for the early institution of a consolidated tape on a basis consistent with the forthcoming central market system. But, although you may not always think so, we are listening carefully to the various points of view, and I am sure this will be worked out.

As to the unfixing of commission rates -- that hardiest of topics which seems to keep cropping up long after it had apparently been put to rest -- we are at least nominally on the same side. We both favor leaving it up to the Commission rather than fixing it by statute. I suspect, however, that we may have somewhat different motivations.

Our espousal of this view is based upon the almost, but not quite, theoretical proposition that the future is always uncertain and, except for matters of broad policy, administrative flexibility is to be preferred. We consistently have opposed writing in stone all of the rules and guides that shall govern us in the future. That, it seems to me, is the very genius of the present legislative structure.

Our view in this regard is not based upon the sly notion that, by announcing our intention to unfix rates, we can talk Mr. Moss into leaving this provision out of his bill, and then, when he has left it out, we can change our minds. We don't intend to change our minds, as I have reiterated on many occasions. If some of you had this thought in your minds, I suggest that you think some more.

I realize that the thought is tempting. The membership of the Commission has had a habit of changing. We now have only one Commissioner who was in office at the beginning of this year, and I am this year's third Chairman. But don't let these facts lure you into romantic fantasy. I am confident that commission rates are going to come unfixed, regardless of who the Commissioners may be, save, perhaps, only for a radical restructuring of the entire brokerage industry along public utility lines, a rather doubtful prospect.

Finally, there is the question of killing the third market. The New York Stock Exchange is pleading before the Congress that this third market must go. The argument goes like this. An auction market is good, indeed essential. There cannot be an auction market without an exchange. There cannot be an exchange without members. An exchange cannot have members unless there is some incentive to retain membership. The only important incentive now is fixed commissions. With the abolition of fixed commissions, there must be a substitute incentive. The only workable substitute is to require all trades in listed securities to take place on the exchange. Ergo, when commissions are unfixed, the preservation of an auction market requires killing the third market. The SIA has officially espoused this view.

I am quite capable of following the syllogisms involved, given the premises. But these premises, to say nothing of the conclusion, are quite remote from what I conceive to be reality.

I can, however, suggest a somewhat different syllogism. We all agree, or at least should, that competition can enhance our securities markets. No one can really doubt that the third market attempts to compete with the exchanges by occasionally doing what the exchange market-makers, or specialists, can't or won't do. Thus, the elimination of this source of competition could prove harmful for the markets. Perhaps the third market doesn't compete fairly because it doesn't report its trades on a tape and it isn't subject to any obligation to clean up limit orders. But, the ultimate application of these principles to the third market in the central market system that we envision is precisely what we have proposed, and we have heard no objections emanting from third market stalwarts -- only from the exchanges.

Even if we weren't so convinced that the third market provides a useful source of additional competition for our securities markets, we would be reluctant to support the outright, and possibly irreversible, elimination of such a traditional business practice without strong indications to the effect that this enterprising sideshow -- which, by anyone's figures, accounts for well under 10 percent of all trading in listed securities -- contains the seeds of the auction market's destruction. We really don't believe it does. In fact, we've always been told by some smart fellows in the industry that the third market really doesn't make very good markets -- it just shaves a little off the fixed commission. They've told us that, if exchange members don't have to charge their institutional customers the minimum commission rate, the third market would lose its edge and quietly, albeit quickly, fade from the scenes.

I guess no one knows what the ultimate upshot of the elimination of the third market really would be, but it does seem a little harsh to kill off the third market just on the slim chance that its continued existence might put our several exchanges out of business. I can't help but recall the warning our predecessors received -- that the inclusion of listed stocks on NASDAQ would destroy the exchanges; it hasn't, at least not thus far. At a minimum, I prefer any alternative which permits us to give things a chance and to see what actually happens. Our views are influenced by experience and our doors remain open. We are always willing to listen to new reports and new ideas.

There are, however, some pretty strong reasons why we now believe that no one will put the exchanges out of business, at least for a long time to come. We've made our views known on this score previously, and there would be little purpose in running through them again this morning. There is a point I would like to make, however, concerning the New York Stock Exchange's third market proposal.

Let us assume that, for one or several economic reasons, the commencement of unfixed commission rates does, in fact, produce a strong incentive for many exchange members to relinquish their membership. Let us assume even further that the Congress were to accede to your requested ban on nonexchange listed trading. Would not the result simply be that all executing brokers would have to be exchange members? It would not mean that all brokers would have to be exchange members. Given these assumptions, commission houses could leave the exchanges but send their customers' orders to the exchange for execution through correspondents, just as nonclearing firms do today.

The only nonfloor firms that would have any incentive, other than goodwill and prestige, to retain membership would be those firms that wish to continue to do their own floor executions and clear their own transactions. Thus, hundreds of member firms might choose to leave the exchanges, even with this proposed ban. It doesn't seem to us that such a ban will do the job it is proposed to do -- assuming that the job needs doing.

It may be naive, but we really do have confidence in the ability of the exchange markets to continue to do what they've historically done -- make the most efficient markets of any capital market system. Of course, if it should start to look as if we might prove wrong, we will take prompt action, and, if necessary, urge Congress to take appropriate action.

I realize that the argument is being made to the Congress and not to us. If you persuade Congress, we will obey the law. We don't try to impound legislation. But even if you should persuade Congress now, I doubt that it will last for long. I am not convinced that we must build the market of the future on either fixed commissions or a stock exchange monopoly.

We at the Commission are also very much aware that what may be attractive hypothetical propositions to us are basic bread and butter items to you. We will never knowingly seek to impose upon the securities industry measures that will destroy the capital markets system that is the wonder of the free world and a key element in the infrastructure of our free society.

I realize what the road to hell is paved with, and I do not mean to be understood to say that we should be excused for destroying our capital markets because we had good intentions.

You, on the other hand, should bear in mind the immense variety of opinion that exists on the crucial aspects of the future's central market system.

I am not one to suggest that these matters should be resolved by any kind of head count. We at the Commission are quite prepared to make decisions that might be contrary to popular vote. That is the duty imposed upon us by the Congress. But it is not entirely irrelevant to suggest that, if all broker-dealers and institutional traders were polled, I am confident that the vote to preserve the third market would be overwhelming. Americans generally don't like monopolies, and exchange specialists have not always performed so spectacularly as to induce many non-member professionals to think that the specialists are entitled to the extensive legally protected monopoly now being sought.

I am, of course, expressing views that necessarily are predicated on the assumption that the major players -- the several self-regulatory bodies, the Commission and the members of the securities industry -- will continue their present roles and retain essentially their present authority. I have referred before to the possibility of a more radical restructuring of the securities industry that would have as its purpose the promotion, rather than the regulation, of the securities industry. And Mr. Rustin reported in yesterday's Wall Street Journal that such radical thinking was gaining some acceptance at this meeting.

No doubt, our views on this matter may be critical to the success of such a program, if it should achieve the status of more than wild imaginings. While this suggestion is, at present, far too amorphous for us at the Commission to have developed any meaningful conclusions, I can, speaking of course only for myself, make clear that we would be willing to give well-structured proposals along these lines careful consideration. Whether governmental sanction of such promotional powers would best be centered in our Commission or in some new agency is even more remote at this time. But it does merit noting that the Commission, as I have come to know it, would not be influenced in reaching any conclusions on this subject by any notions of bureaucratic empire building. If the program is good, and a new agency the best vehicle to promote it, I can assure that we would not harbor any jurisdictional jealousies that would clutter clear thinking on our part.

How can we view the future? In the recent issue of Forbes, I encountered a wonderful statement from Walt Disney, when he said, "We are confronted by insurmountable opportunities." From my relatively objective vantage point, it seems clear that the securities industry is confronted by opportunities that are existing and ready to be grasped.

Yet to many of you -- having in mind your own special view of the world and your own source of livelihood -- these opportunities must indeed often appear insurmountable.

I can only urge you into the battle to surmount these opportunities. The securities industry in its many roles has a major part to play in enabling our free society to persevere through the fearful demands of the rest of this century. It is now like the lobster that has shed its old shell and is temporarily defenseless. The new shell must be grown and grown fast. Else the industry will not be able to face the demands that will shortly be thrust upon it, and others will move in to do, less effectively, what this industry should do.

Such an endeavor -- the growing of the new shell, the moving to a more stately mansion -- requires the best efforts of all of us. Unlike many past periods of upheaval, the Congress is a major ingredient in any resolution of today's problems. So is the Commission, thanks to Congress. But most importantly, so are you.

It is difficult for me to stand here and exhort you to foster measures that you believe will impoverish you. Few of us are so self-denying. But I am not really urging any such thing. What I am urging is basically simple: (1) that you accept the reality of fundamental change in your industry; (2) that you abandon the idea that the old system will work well for current and future requirements, even though in the past you prospered under that system; and (3) that you set your goal as that of bringing a new system into being, realizing that the development of the new system should not and cannot be used as an opportunity to preserve old protected monopolies or to create new ones.

If we can all get in this frame of mind, respecting each other's particular interests but keeping our eye on the main chance, and resisting the temptation for power plays, then I am confident we can work these things out. We all know that nobody is going to get everything he wants. We should also know that reasonable men can reach reasonable accommodations in order to perform the economic functions so desperately needed in the days to come.

That's the American way.