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SOME REFLECTIONS ON COMPETITION AND THE NATIONAL MARKET SYSTEM

Remarks of

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It has been suggested that I discuss future problems and current rulings with particular emphasis on what the future market place will look like and the SEC's role in its creation and control. Unfortunately, it is not yet possible to be specific on these matters nor is my crystal ball up to that assignment. Consequently, I propose to consider the framework within which decisions in these areas will have to be made and certain of the considerations which will shape those decisions.

The first and over-riding consideration is that the national market system is no longer merely a concept, the merits of which are a subject for academic debate. The Congress has determined that a national market system should be created and has written that determination into law. It has specified certain objectives which it finds that this system should accomplish and has determined that the "linking of all markets" will further those objectives. It has not, however, specified exactly who shall create it.

The Commission is directed to use its authority under the Securities Exchange Act to "facilitate the establishment of a national market system" and Congress required the creation

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of a National Market Advisory Board which, among other things, is to recommend to the Commission steps to be taken to facilitate the establishment of the system. The Board is specifically directed to make recommendations as to the governance of the national market system and resulting modifications of the scheme of self-regulation to adapt it to the national market system. Significantly, its recommendations on this topic are to be transmitted not to the Commission but directly to the Congress, and a deadline of December 31, 1976 is fixed.

This method of legislating is novel in the securities field but seems to represent a recent trend in Congressional action. The original Securities Exchange Act was drafted quite differently. It provided in numerous sections that specified conduct was unlawful, or that certain people should do certain things. It created an agency and authorized it to adopt rules for specified purposes and to enforce the law. It required certain organizations to register, and thereby to be subject to regulation.

By contrast, Section 11A of the new Act simply specifies objectives and directs the agency and, by necessary implication, the securities industry, to do whatever is necessary to accomplish these objectives. Congress has

done this kind of thing several times in recent years, notably in the National Environmental Policy Act, but this approach to legislation is new to the Commission and the securities industry and will take a bit of getting used to.

I would read the legislation as not determining any specific role for the Commission in the creation or control of the national market system and as contemplating as significant a role for the securities industry as that industry is able and willing to take. Some of the decisions are concrete business decisions, involving, among other things, the investment of money in the creation of facilities. That type of decision should be made by the industry. But the Commission will simply have to do whatever it finds necessary and within its authority to do in order to accomplish the Congressional purpose. I would like to see the industry take a leading role, but that is up to the industry.

The national market system has been discussed for about five years, commencing, perhaps, with the Commission's letter of transmittal for the Institutional Investor Study in March 1971, followed shortly thereafter by the Martin Report to the New York Stock Exchange. It has been discussed in two related but different ways. The first is in terms of concepts and objectives culminating with the authoritative statement

by the Congress in June 1975. The other is in terms of building blocks to be set into place one by one until the structure is completed. The principal building blocks so far are a consolidated tape, which was mandated by the Commission and is now in operation, a consolidated quotation system, which was left largely to private initiative, and is now starting to emerge, and the consolidated limit order book, which the Commission has suggested be expedited in Securities Exchange Act Release No. 11942 of December 19, 1975, adopting Rule 19c-1 with respect to off-board trading by exchange members. One reason for delaying the full effectiveness of this rule for one year was to afford the industry and the self-regulatory organizations an opportunity to exert their best efforts to achieve such a limit order book. That release mentioned certain other initiatives which have been taken to further the achievement of a national market system.

At about this point the analysis of the national market system in terms of concepts and in terms of specific building blocks tends to come together. As some building blocks go into place and others are being designed, we are faced with hard decisions as to who will be allowed or required to use them, who will control them and on what terms, who will pay for them and how, and exactly how they will be designed and

precisely what will they be capable of doing? These decisions must be made within the framework of concepts and characteristics of the national market system, particularly those enumerated by the Congress.

One of the key concepts and characteristics is competition. One of the major purposes of the Securities Acts Amendments of 1975 was to eliminate restraints in competition not justified by the purposes of the Exchange Act. With specific reference to the national market system the Congress concluded that such system should assure "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets."^{1/}

Competition in the securities business, and particularly "fair" competition in that business, takes numerous forms, can be defined in a variety of ways, and looks very different depending upon the vantage point from which you look at it. It is, therefore, very difficult to get a handle on this issue of "competition." Looked at in one way the securities industry is a highly competitive business, which unlike, for example, the automobile manufacturing business or the airline business, is relatively easy to enter and which comprises hundreds of firms competing vigorously among

^{1/} Section 11A(a)(1)(C)(ii) of the Act.

themselves, and with other financial institutions such as banks, insurance companies and others, for the favor of investors. The industry includes a good many quite different segments. The mutual fund industry, for example, is, at once, an integral part of the securities business, and a competing investment medium. On the other hand, the securities business is a highly regulated business. Numerous legal and self-regulatory requirements designed to protect investors limit the freedom of securities firms to pursue certain competitive tactics freely employed elsewhere. Indeed the securities business quite often refers to itself as a profession. There is also some uncertainty as to what it is selling and competing in. Is it merchandising securities or is it providing a service, and, if so, what service? Is the service merely the execution of transactions, or is it that plus investment advice or financial management?

Whatever the securities industry is selling, it has often been unable or unwilling to engage in price competition. Insofar as securities themselves are concerned, it is often illegal to sell them at prices above the market and impractical to sell them below it. From 1792 to 1975 the exchange fixed minimum commission rates. These rates included a variety of services, in addition to execution, and members increasingly competed in terms of the number and the quality of the

additional services they offered. This meant, among other things, that it was practically impossible to determine whether the commissions were reasonable since one did not know exactly what they were buying and this varied from firm to firm and from time to time within a firm. New Section 28(e) of the Exchange Act endeavors to define what is being bought, at least by a fiduciary, as "brokerage and research services" with the additional feature that the research services need not pertain to the particular transaction. The meaning of this section is further expounded in the Committee reports which make the point that commissions paid to one broker cannot be used to pay for services furnished by another broker, thus avoiding any blessing for reciprocal dealings.

I hope I have succeeded in convincing you that competition in the securities industry is not a simple concept, like competition between two grocery stores. But the passage I quoted from new Section 11A of the Act raises further problems which have particular relevance to the national market system and also to the off-board trading rules which I mentioned.

This provision of Section 11A endorses fair competition among broker-dealers and among markets. This idea of some sort of dual competition raises a number of questions which are rather crucial in the evolution of the national market system. Normally competitors are thought of as competing within the market for a particular product. Different

products may compete with each other for the favor of consumers but, with respect to a particular product, there is usually competition between participants in a market not between markets. But as the securities industry has evolved, it has both kinds.

This has resulted, I think, from the fact that historically, exchange markets have tended to organize themselves as exclusive bodies, sometimes invidiously called "clubs," to which only members who acquired "seats" were admitted. Members were protected from non-member competitors by fixed minimum commissions which were paid not only by ordinary customers but also by the non-member broker-dealers. When executing orders within an exchange market, member brokers tended to cooperate with each other about as much as they competed. The buying broker was the selling broker's ^{2/}customer. The market making or dealer function for each security on an exchange tended to become a monopoly in the hands of one person or firm once the exchange had moved from the call system to a continuous market in all listed securities.

^{2/} In connection with this analysis, I am indebted to a provocative article by Professor Walter Werner in the November 1975 issue of the Columbia Law Review (75 Columbia L. Rev. 1233). I should add that I do not agree with a good many of his conclusions.

I do not know why this concentration occurred, since market making is not a natural monopoly, as witness the over-the-counter market and the third market, but it did occur; competing specialists died out on the major exchanges some time ago. Perhaps the monopoly feature resulted from the pivotal and influential position that market makers, or specialists as they came to be called, occupied in the exchange structure. Or perhaps, as someone explained to me once, competitors who stand side by side at the same post all day, with each of them observing exactly what the other is doing, just naturally tend to cooperate or merge rather than to compete. The same thing happened to the odd lot dealers.

Meanwhile, those brokers, or would be brokers, who were left out of one market attempted to create other markets. This usually did not work for the same securities in any one city, but geographically separated markets survived.

Now, in theory, at least, there are strong arguments for the proposition that separate and competing markets, are not a good idea. They tend to fragment the order flow, and to result in situations where a broker who is confined to one market is unable to execute his customer's order at a better price which is available in another market. Moreover, concentrating the order flow in one market maximizes the opportunity for public orders to meet without the intervention of a dealer, and would seem to promote liquidity

These objectives, best execution and an opportunity for orders to meet without the participation of a dealer, are among those specified by Congress for the national market system.

But when the Commission came into existence in 1937 it was confronted with a condition not a theory, and we still are. Although the New York Stock Exchange was the dominant market for stocks of national interest, the regional exchanges existed and met regional needs, not only by providing local markets for local stocks but also by providing local markets for national stocks. The idea of giving the New York Stock Exchange, with all of its restrictive practices, a total monopoly was not attractive even had it been feasible. In any event the Commission, in the years prior to World War II, resisted, as anti-competitive, measures by the New York Stock Exchange which would have crippled the regional exchanges.

In recent years improved communications technology has made a national market for stocks technically feasible, which it probably was not before World War II. The New York Stock Exchange, however, has not evolved into a national market system. Even if one assumes that it could have, certain restrictive practices precluded that development.

Notably among these were the fixed minimum commission, the monopoly position of the specialist, and the limited membership. Institutional investors went off board and off the floor, in order to avoid the minimum commission or to avoid being wholly dependent upon a specialist's ability and willingness to deal. Non-member brokers and dealers, and regional exchanges were glad to accommodate them. This accentuated the problems of fragmentation, which the New York Stock Exchange deplored and sought to offset by measures such as Rule 394.

The elimination of fixed minimum commissions would seem to improve the ability of the New York Stock Exchange to compete with other markets, particularly for institutional business which is sensitive to opportunities for commission savings. At the same time it eliminated the incentive for some firms to retain or acquire exchange membership as a shelter from price competition. This is by no means the only example of situations where the objective of competition between markets and the objective of competition between broker-dealers seems to run in opposite directions. Another example is the fact that division of the order flow among the larger and the smaller markets would seem to further the ability of the smaller markets to compete, but it would also seem to reduce the competitive opportunities of market makers

in particular markets who are very dependent upon order flow as well as the ability of brokers in any market to execute orders against the entire flow.

The resolution of these apparent conflicts which is visualized by the Congress appear to lie in the concept of "the linking of all markets for qualified securities" also expressed in Section 11A. This would appear to contemplate that, to the extent possible, the total order flow be made available to all markets so that brokers in each market may execute orders against it and all market makers may have the benefit of it in making their markets. In a sense, it could be said that any market structure which brings within it a common order flow is one market rather than several and I think that it is in that sense, that the singular term "a national market system" is used in the Act. We now have, as you all know, several markets in the sense that everybody in the business is not in one place, rather they are scattered from coast to coast. Congress contemplated that they could continue to be so scattered and, for what it is worth, I agree.

Consequently, the job before us is to set up a mechanism both of facilities and of rules, which will make the order flow available to various markets centers and to make it

possible for all to participate in it on equal terms. I believe that it is technically possible to make the order flow thus available and that rules can be devised to permit equal competitive access to it. This, however, is not an easy job, and it will involve sacrifices of competitive advantage by some. Nevertheless, I think that this is what is meant by the national market system which Congress has mandated.