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THE NEW BREATH OF COMPETITION

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Securities and Exchange Commission

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Two weeks ago today there occurred one of those rare instances in which, by clear cut and unambiguous action, the government retreated from an area of regulation and left it to the forces of competition to do what it, in collaboration with the regulated industry, had previously done through regulation. After 183 years of fixed commissions, during forty-one of which the fixing occurred with the tacit and sometimes active aquiescence of a governmental agency, the practice was brought to an end by government action, amid strong efforts by elements of the industry to cause the agency to reverse its action or have higher governmental authority overrule it. Rarely, if ever, has so explicit a system of price-fixing been so summarily ended. True, frequently price-fixing practices have been brought to an end by judicial decree. In those cases the practice was usually covert, depended for effectiveness upon the disposition to compliance of the participants in the

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practice, involved only crude and limited means of enforcement which operated with limited efficiency, and suffered from all the difficulties of operating out of the public sight. In the case of commissions on securities transactions the situation was much different. Here there was nothing clandestine or secret: the structure of prices was set forth in detail in the constitutions and rules of the New York Stock Exchange and the other exchanges. The means of enforcement were not subtle or secret: the member either complied or lost the privilege of exchange membership (of course, there developed innumerable loopholes and evasions that eventually helped to hasten the demise of the system). Notwithstanding the various means of avoidance that developed, for the most part the system worked well; it is probable that the overwhelming number of transactions that occurred in listed securities in this country were executed for commissions fixed by the exchanges.

The system of fixed commissions originated and developed without governmental sanction and survived for years after price fixing had been declared illegal _per se_ and before it gained any sort of governmental sanction. The Securities Exchange Act of 1934 gave it that sanction by bestowing on the then newly created

Securities and Exchange Commission the power to pass upon the reasonableness of exchange commissions.

The extent of the price fixing now ended went beyond that contemplated by the original Buttonwood Tree Agreement and the Securities Exchange Act of 1934. The original agreement and its extensions and elaborations bound only the members of the New York Exchange in their activities on that exchange; it was not intended to bind those who dealt on other exchanges. And yet through the years the rates on the New York Stock Exchange became in virtually all instances and for all purposes the rates charged for transactions on the other exchanges and, more than that, they became the prevailing rates for agency transactions in the over-the-counter market. Thus there developed a pervasive system of price-fixing in which not only the members of the New York Stock Exchange under the benign eye of the Commission joined together through their instrumentality, the Exchange, to fix the prices at which they would market their services on that Exchange, but the New York Stock Exchange and the other exchanges engaged in what might at least be characterized as "conscious parallelism", impliedly countenanced by the Commission, and the members of the securities community, again through conscious parallelism, but in this instance without the sanction of any governmental agency, extended the practice to a large part of

the over-the-counter market.

Mayday has come and gone and there is fear in the land that the consequences of it may be graver than foreseen. After what appeared to have been a mild modification of the previously prevalent price structure, during the last ten days we have seen sharp price-cutting, in some instances to half or less of the previously prevailing rate. A variety of practices has arisen and there are rumors of all kinds of special and unusual deals about. The Commission is engaged in a systematic and extensive effort to monitor the consequences that flow from all this. We have assured the securities industry that if it appeared that consequences flowed from this change which might endanger the interests of investors we would be disposed to take measures to ameliorate those consequences, though, speaking for myself, I would think we would exhaust many possibilities for amelioration before we restored the system of fixed commissions that existed before May 1, 1975. Our monitoring is to provide us with hard facts to determine whether indeed there is justification for Commission interventions.

Of perhaps more importance than the providing to the Commission means of determining what short run measures might be necessitated to avoid consequences from this change inimical to the interests of investors and markets is the fact that our monitoring program, carried on with the active and willing collaboration of the self-regulatory agencies, will provide everyone with the most comprehensive contemporarily developed survey of the consequences of a shift from a fixed price system to a competitive pricing system that we have had. In the past when there has occurred an unfixing of prices as the consequence of judicial decree or antitrust settlement, there was no motivation, other than scholarly, for monitoring during the transition period the consequences of the shift. Furthermore, there was generally no agency with the legal power or resources or interest to assay with care what happened on the days before the end of the anti-competitive practice and the days that followed. Furthermore, the very clandestine nature of the previous practice made difficult the assembly of information concerning market shares and pricing practices during the pre-unfixing period.

Through this monitoring program we expect to accumulate such information as this: what is the effect on revenues of reductions in charges brought about as a consequence of eliminating fixed commissions? whom do reductions hit, and to what extent - small brokers, large brokers, so-called institutional brokers, research boutiques? what effect does the elimination of fixed commissions have on the markets in which business is done? will it restore to the New York Stock Exchange activity which drifted into the third market or regional exchanges because of the inflexibilities of the commission structure? what will happen to the spreads of market-makers?

These are only a few of the questions we hope to find answers to during our post-Mayday survey. This research will not only yield information that will be helpful to the Commission in evaluating the consequences of unfixing and suggesting what, if anything should be done, to protect the investor and markets, but will provide interesting information concerning broader questions about market behavior in the presence of fixed rates versus unfixed rates.

The elimination of fixed commissions is but one of many profound changes that are occurring in the regulation of the securities industry and it is not the only one that is marked by a strong pro-competitive flavor. Congress is on the verge of enacting the most comprehensive modification of the system of securities regulation since the Securities Act of 1933 and the Securities Exchange Act of 1934 and that legislation leans strongly toward the enhancement of competition.

The securities industry is characterized by one of the most unique regulatory structures in the country, perhaps the world. Typically securities exchanges have come into existence as the consequence of private initiative, though increasingly in countries which have not had highly organized markets and which desired them the process has been accelerated by the activity of governmental bodies. The private initiatives had many sources: exchanges were organized to avoid ruinous practices among the professionals involved in the process; they were designed to provide a centrality of trading that had tended to disperse; they were to facilitate communications at a time when the range of the human voice was at most a few hundred feet or so; rarely was the organization of exchanges motivated by a desire to perform

a public service. Generally these initiatives resulted in rules concerning the admission of those entitled to use the facilities (usually capital capacity, technical proficiency and good character were the requisites); rules concerning the manner in which transactions could be done (for instance, rules concerning settlement, obligations of performance, the allocation of revenues related to the security during the transaction period), the times during which and places where the transactions could occur (opening and closing hours, activity confined to the exchange), and rules concerning the prices which could be charged for services. As markets gained in sophistication and experience, these rules were increasingly complex, specific and, in all fairness, restrictive.

In many countries the exchanges continue to be largely independent of government regulation and privately organized and run; for instance, the London Stock Exchange is only lightly impacted by government policy and its affairs continue to be run in a remarkably private manner. One of the reasons that the London Exchange has succeeded in escaping tighter government regulation so far has been the high sensitivity of it and other elements of the financial community to the development of practices contrary to prevailing expectations concerning market conduct. For instance, in the face of heightened take-over and merger activity posing innumerable

opportunities for overreaching and abuse, the Bank of England organized the City Panel on Take-overs and Mergers to regulate such conduct. Because of the unique organization of the financial community in Britain this body, lacking the customary enforcement tools of a governmental body, has nonetheless been effective in enforcing its wishes on the financial and corporate community in the United Kingdom.

Until 1934 the exchanges in this country were privately owned, privately organized, privately operated, and privately controlled free of any governmental interference. Their rules were not subject to any governmental review or enforcement; the members of the exchanges constituted a community, a closed circle, in which perhaps the most predominant precept was that they conduct themselves as gentlemen, at least in their dealings with each other, if not with the outside world.

The investigations that grew out of the 1929-1933 debacle exposed a multitude of shortcomings in this system. The rules of the New York Stock Exchange lent themselves to cunning use by insiders resulting in unconscionable speculative profits usually at the expense of outside investors who implicitly, even blindly, trusted in the integrity of the process, largely because they had no means of knowing any better, since the operations of the exchanges were largely mysterious, their affairs

conducted in secrecy, and their controls indeed light. In 1934 there began a process that has not yet ended, a process by which the previously all-private status of the exchanges and the securities markets succumbed to increasing regulation by the government of their processes. In that year "self-regulation" as we now understand it began. This meant simply that the exchanges might indeed continue to regulate their own affairs, but such regulation was subject to the overriding power of the Securities and Exchange Commission to compel modifications of the regulatory pattern in the public interest. The manner, however, of the Commission's exercising its powers seemed cumbersome, time-consuming, and as a consequence, through the years were rarely used.

This modification of the traditionally private nature of the securities markets of the nation was unique. Congress could have placed the exchanges and the securities industry under more direct and extensive controls and have made them in effect public facilities. It chose a subtler and, in some respects, more complex course. The concept Congress developed was extended in 1938 with the adoption of the Maloney Act amendments to the Securities Exchange Act of 1934 which provided for self-regulation of the over-the-counter market as well as the activities of most

of that portion of the broker-dealer community which was not affiliated with any exchange. Under this system the exchanges and the NASD, which was organized under the Maloney Act as the self-regulating mechanism for the over-the-counter market, retained considerable power to regulate the affairs of their respective members, to adopt and enforce rules concerning a multitude of topics, and generally to act as the first line of regulation of the securities industry.

This structure filled out so that virtually all the securities dealers in the country doing business with the public were members of the one or more self-regulatory mechanisms. As a result these self-regulating agencies have two-and-a-half times as many people as the SEC; this comparison is even more remarkable when one considers that a large number of Commission employees are not concerned with regulation of the securities industry and the securities markets, but are rather concerned with disclosure policies affecting American industry at large.

As a consequence of the abuses and insufficiencies that became apparent in the late sixties - the paper glut, the hazards to which the investing public was exposed by securities firm failures, the obvious creaking of the established machinery, both houses of Congress began intensive and extensive investigations of the securities markets. One of the principal foci of this inquiry was the operation of the self-regulatory mechanism. Congress' conclusions were that there was indeed sufficient merit in the system to justify its continuance, but that it was in need of extensive repairs. These they have made is the legislation now on the verge of enactment. The various self-regulatory bodies will continue to be privately owned, privately run, but their affairs will be much more subject to Commission oversight than before. The opportunities for Commission intervention in the self-regulatory process will be expanded, procedures will be refined, a large number of specific mandates will be laid on the self-regulatory authorities, and the Commission will be ordered by Congress to take specific measures with respect to the self-regulatory bodies, for instance, review their rules to determine the extent to which they are anti-competitive, especially insofar as exchange members are inhibited in seeking the best execution for their customers. In addition to all this the Commission is

being told to take such measures as it deems appropriate to facilitate the development of a national market system. This mandate to the Commission is a new challenge and one different from those given it in the past. Historically the Commission had been told to regulate existing entities and systems, to oversee them, to moderate and modulate their conduct when necessary in the public interest. Now the Commission is being told to take affirmative measures to bring into existence something new, a national market system.

Many critics of the new regulatory scheme have foreseen as a consequence of it the demise of the self-regulatory system, with the Commission exercising its expanded power in a manner that will result in the exchanges and the NASD becoming nothing more than fingers of the Commission, responding obediently to its urges with little or no opportunity for initiative or action reflecting the unique familiarity with the industry and the markets of those guiding their affairs.

There is no question that an aggressive governmental agency cloaked with extensive power always holds within itself the potential for mischief, the possibility of expanding steadily outward its prerogatives. I do not see that happening in securities regulation. First, there are distinct limits to the manner in which the Commission can exercise its power under this new legislation. In every instance I can think of in this

legislation there are standards against which the legality of Commission conduct must be measured. More than that perhaps is the historical fact that the Commission has acted with responsible restraint. Furthermore, the Commission's regulatory cloak has rested lightly on the exchanges and the NASD; rarely has the Commission overridden exchange or NASD measures which they felt strongly were necessary for the conduct of their functions. Indeed, "cooperative regulation", a term first used in 1938 and recently revived to describe the thrust of the new legislation, has been the fruitful pattern of the past; this has occurred, at least coincidentally, if not in a cause and effect relationship, with the growth of our markets and the long-term prosperity of the professionals who have participated in them.

During the last couple of years there has grown an increasing restiveness under the strictures of government regulation. Even some of those who in the face of every problem in our society and our economy cast longing eyes at Washington have begun to

question the desirability of regulation and the extent to which it hinders rather than helps the public interest. The wreckage of the railroad industry is by many laid at the door of too much regulation, fears are expressed that the same fate may await the airlines if the hand of regulation on that industry is not lightened. The President has indicated clearly his conviction that the regulatory agencies may have worsened inflationary pressures by imposing practices that result in higher costs than would have prevailed had there been more opportunity for market mechanisms and competition to work.

Notwithstanding these misgivings, however, the fact is that in innumerable areas we see the expansion of regulation. In the environmental, safety, occupational, and innumerable other areas the blanket of regulation has reached out further and further.

This new securities legislation opts strongly for competition; it is deeply colored with the idea of competition and its enhancement. Backing up the Commission's regulatory mandate it outlaws fixed commissions; it orders the Commission to take such action as it deems necessary with respect to self-regulatory agency rules to eliminate anti-competitive influences; it mandates the establishment of a central market system to which all qualified brokers and dealers will be admitted without arbitrary limit; it looks toward the reduction of the significance of the seat on exchanges. It is rife with hostility to anti-competitive

influences in the securities markets. And that, I suggest, is a minor revolution. Most of all, it is a good one.

As the relationship of the Commission and the self-regulators undergoes significant change as a result of the new legislation, there is a continuing concern over the future style and mode of self-regulation.

The most basic self-regulatory problem we now have is how the markets of the nation are to be regulated, particularly as we move toward the new national or central market.

There are about as many conceptions of what the terms "central market" and "national market" mean as there are people using them. Often people speak of opposition to the continuation of separate market-makers operating in different markets, while endorsing the idea of competing market makers functioning within a single market. Frankly, I think much of the discussion is academic and consists of people using different words to convey essentially the same idea. The dominating concept underlying the idea of a central market system is that there should be competition among those who make markets in a security and the maximum opportunity for users of the system to realize the benefits of that competition. Thus at a minimum any national or central market system will permit efficient means for determining the quotes in all relevant markets and executing in the market that offers the best execution for the customer.

Obviously there should be appropriate regulation of all those in the system if there is to be elemental fairness to the participants.

We are only now focussing upon the difficult problem of how this new system should be governed. During the last session of Congress and in this one Congressman William S. Stuckey, Jr. proposed the organization of a National Market Board consisting of industry and public representatives. Various versions of this have surfaced since he first suggested the statutory vivication of such a body. Under one version - the one approved by the conference committee -- the board would be an advisory board which would advise the Commission how it should go about setting up and regulating the central or national market systems. Under other versions the board would have become the self-regulatory entity which would govern the new system once it is established, much after the fashion the various exchanges and the NASD regulate their respective markets: the board would adopt a constitution, by-laws and rules which would, like those of other self-regulatory agencies, be subject to the oversight responsibilities of the Commission. A somewhat different version of this proposal was introduced by Senator Williams. This would have provided for the organization of a Council which would have representatives of the many interests involved in the securities process in this country, as well as public members. A simpler proposal was

put forward by the Yearley Committee, a committee created by the Commission to advise it with respect to the organization and regulation of the central market. Under this proposal all the exchanges would be merged into a single exchange, much as was done in England, and the regional floors would be simply local presences of the single exchange mechanism.

This is a profoundly difficult problem. While the Commission had indicated a sympathy with the idea of some effective mode of self-regulation with respect to the new emerging market system, there is still considerable uncertainty about the manner in which it should be organized, the powers it should have, the relationship it should bear to the other self-regulatory agencies and the Commission, and the mix of people who should be on its governing body. Wisely, the conference committee has chosen to permit further study of this difficult problem.

A further fundamental self-regulatory problem is the existence of exchanges and the NASD all involved in regulating the non-market activities of their members. Each of them is responsible for the conduct of a market, in the case of the exchanges their respective floors and in the case of the NASD the over-counter-market. But more than that, each of them also regulates many of the affairs of its members, not solely related to the market it operates, e.g., net capital compliance, compliance with rules pertaining to the qualification of personnel, recordkeeping, and

the like. Over the years various mechanisms have developed to minimize the duplication that would result from membership in more than one organization. The most notable was included in the legislation which established the Securities Investors Protection Corporation (SIPC). This gave SIPC the power to designate a self-regulatory agency with respect to each SIPC member which would have the primary responsibility for policing the capital requirements applicable to the member. The pending legislation expands that and would give the Commission the power to designate a self-regulator which would perform the entire job of self-regulation as it relates to a member of the industry. I would hope that paralleling the development of a mechanism for regulating the central market system there will be a rather extensive review of the activities of self-regulating organizations which do not relate directly to markets. There appears to be duplication among the self-regulating agencies, though less than some would suggest, but sufficient to justify concern with it.

I think it would be well for everyone if action were taken soon to combine all the non-market related self-regulatory functions into a single agency which could function irrespective of the various markets and be exclusively concerned with the manner in which the industry, to use a modern term, interfaces with the public. Everyone in the industry would be a member of

this organization; it would administer net capital and other financial requirements rules; it would administer admission to the industry; it would impose penalties for infractions of the rules with respect to dealing with customers. It would administer recordkeeping rules, compliance with the plethora of rules that bind upon everyone in the industry regardless of whether he is a member of an exchange or not.

This idea is not a new one. Senator Williams suggested it two years ago on the occasion of the 35th anniversary of the Maloney Act. Then Commissioner, now NYSE Chairman, James J. Needham favored such a restructuring. There is a substantial body within the industry that believes such an effort would yield economies and efficiencies of regulation. More than anything, it would, in my estimation, strengthen the principle of self-regulation or cooperative regulation within the industry. It would eliminate rivalries that benefit no one, neither the public nor the industry. Were such action taken promptly, before the need for resolving the intricate questions of regulating the central market had to be confronted, much of the confusion and difficulty of resolving that problem would in my estimation disappear. However, I doubt much whether anything that complex, involving as many people and interests as it does, can be done quickly. Furthermore, we will be reminded and will consider

the view that service and technological innovations have come from self-regulatory organizations' competitive efforts to attract and maintain their membership and that there should be more than one audience for new ideas. In any event, I would urge upon industry leaders that they turn their energies to the restructuring effort. They preeminently have the most to gain from it, as well as the power to accomplish it. Perhaps the Securities Industry Association, which is seeking a larger role in representing the industry, might make this its foremost objective and through its accomplishment reinforce its prestige and standing in the industry and, indeed, in the nation.

A new breath of competition is blowing through the securities industry. For some it is chilling; others it warms with the hope and expectation of new opportunities and rewards. Ancient franchises are imperilled, novel experiments abound. This enhancement of competition in the securities industry constitutes a reaffirmation of belief in a verity that is at the heart of the American economic system: that when free men compete freely with each other for the favor of the public, the public wins. May this be the first of many such reaffirmations.