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CHALLENGES FACING THE SECURITIES INDUSTRY

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It's a pleasure to be with you today. As the very existence of this conference indicates, we are in a time of change and new opportunities which require flexibility and innovation on the part of our securities markets. Accordingly, conferences such as these are critical in order to focus the debate and identify an agenda for change. For my part, I would like to provide some perspective as to what I believe the real opportunities for change may be and review the role of the Commission in facilitating any such changes. In understanding the Commission's role, however, it is helpful first to understand how the markets developed to their present position.

In 1975, Congress enacted sweeping amendments to the Securities Exchange Act which, among other things, empowered the Commission to "facilitate the development of a national market system." This "National Market System" was not defined by Congress. Instead Congress blessed us with a set of broad, sometimes conflicting, goals and objectives ranging from enhancing fair competition, efficient execution of transactions and opportunities to achieve best execution of customer orders, to providing for market linkages and the broad dissemination of market information. All of this to be accomplished, where possible, through a trading structure that permits investor orders to be executed without the participation of a dealer.

The '75 Act Amendments were both backwards and forwards-looking. In part, they responded to the competitive and market

fragmentation concerns of a growing third market; a market which developed in response to increased institutionalization and fixed commissions. The third market, however, shrunk dramatically in size after the unfixing of commissions and the "market fragmentation" problem of great focus in the early 1970's became less significant. The legislation also cited, however, concerns of continued relevance today. Congress looked to the oncoming revolution in computer and communication technology and thrust on the Commission the task of fashioning a structure that would encourage competition, absorb levels of heretofore unimagined trading volume and ensure that U.S. securities markets would continue to provide unparalleled depth and liquidity.

To state the task is to underline its uniqueness among Commission mandates. The Commission fundamentally is a full-disclosure and anti-fraud enforcement agency. It has built its reputation for excellence and independence by never straying from that focus. Yet, Congress in 1975 directed us to enter the far more perilous proactive waters of market structure. In truth, Congress carefully contoured these new Commission responsibilities, underlying that the Commission's role was not to design and construct but to "facilitate" the development of the national market system; and for the last fourteen years the Commission has accepted that role, setting out the functional requirements of a modern market structure, prodding the markets towards cooperation and progress and, where necessary,

dictating the fundamental requirements of a national market system.

With the growing internationalization of the securities markets, the Commission's national market system has once again moved to center stage. Many commenters invoking a vision of a fully automated 24-hour security market argue that the U.S. markets have become dangerously unresponsive and risk being eclipsed by Europe and Japan. In order to properly evaluate these Cassandraic warnings, however, we must first look back to see what the U.S. markets have accomplished in the last fifteen years and then look carefully forward with the discipline to separate reality from myth in defining our market's future challenges.

National Market System Progress

During the last fifteen years computer and communications technology have been brought to bear to yield fairer and more efficient securities markets. Real-time quotation and transaction reporting is available for both exchange-listed and NASDAQ National Market System Securities. The Intermarket Trading System ("ITS") electronically links all markets in listed stock, permitting brokers to reach a superior quotation in another market. Finally, each of the exchanges and the NASD have developed automated order handling systems which permit the efficient handling of small orders. The NASD, CBOE and regional exchange systems provide an automatic execution at the best bid or offer quotation while the NYSE has interfaced its

order routing system with an electronic book in order to permit the specialist to execute the order and route a report in a completely paperless transaction.

What the systems in place permit is fairly obvious. We have widespread dissemination of market information from all competing marketplaces. The ITS permits a broker to reach a superior quotation in any linked market, and provides regional specialists and third market makers a fast and inexpensive means of laying off order imbalances. Finally, automated order handling systems have permitted the markets to handle the increased volume levels in recent years without significant trading delays. Moreover, in response to the difficulties these systems did encounter in handling the unprecedented volume levels during the October 1987 Market Break, the exchanges have substantially increased the capacities of their automated order handling and execution systems.

It is also easy to summarize what the Commission's national market system program has not resulted in; there has been no forced shift in the structure of the markets away from an exchange auction model to either a dealer based system or to a fully automated trading system. The Commission's philosophy has been not to force structural change but instead to provide a regulatory environment in which alternative systems may be implemented and used where market forces prefer them over traditional means of trading. Examples of this philosophy have been the Commission's approval of the Cincinnati Stock

Exchange's National Securities Trading System ("NSTS"), the no-action provided Instinet and other proprietary trading systems and the Commission's prospective removal of exchange off-board trading restrictions.

Looking to the Future

I believe that the Commission's national market system choices have been sound. They have yielded linked exchange market places which provide enhanced best execution opportunities and, to some extent, greater competitive opportunities for regional specialists. They also have resulted in a more efficient and open NASDAQ market with quotation and transaction information comparable to the exchange markets.

Yet observers can reasonably ask whether what was good policy for the 70's and early 80's remains sound policy as we head to the 1990's. Today, we are faced with undeniably more international securities markets. Moreover, as was dramatically demonstrated in the October 1987 Market Break, there has been a sea change in institutional trading strategies from individual stock trading that has placed significant new pressures on market liquidity.

Some commenters have suggested that these trends foreshadow a dramatic change in the structure of the securities markets resulting in 24-hour trading markets which, in turn, only can be accommodated efficiently through fully automated trading systems. I believe this vision of the future raises

significant issues which should be taken seriously, yet, for the reasons stated below, I believe this vision is seriously flawed.

This vision is based on two assumptions, the movement to genuine 24-hour trading markets and the superior efficiency of automated trading systems. Yet any suggestion that today's trading markets are 24-hour in scope is simply not true. At least with equity securities, trading continues to search out liquidity; and liquidity, with few exceptions, continues to repose predominantly in the home country market. The reasons for this are not mysterious. Notwithstanding increased foreign ownership, the great predominance of public float in most companies remains in the home country. Thus, the ability for market makers to attract sufficient order flow to encourage profitable risk taking generally does not exist outside the home market. This varies significantly from exchange rate and government bond markets where ownership of the underlying assets have truly spread world wide and relevant news regarding those markets occurs around the clock and around the globe.

Thus one must be careful in evaluating the competitive opportunities and risks entailed in the expansion of international secondary trading. I see little likelihood that foreign markets will compete effectively with U.S. markets in U.S. securities during our traditional trading hours. Similarly, I see little opportunity for our markets to attract significant order flow from foreign markets in their primary

trading hours. The dependence on liquidity and the resulting centripetal forces built into the world's equity markets are simply too strong -- no matter whether that home market employs an exchange or over-the-counter trading system.

I also question the suggestions that automated systems will become the preferred manner of trading. Trading systems which provide for the automatic execution of quotations create new market making risks which are not associated with face to face or telephone trading. Automatic execution exposes market makers to the risk of being "picked off" by other market professionals before they can respond to news or changes in other participant's quotations. This "pick off" risk may discourage market makers from trading in size and, as a result, reduce the potential depth and liquidity of any such system. Evidence of this problem can be seen even in the operation of the NASD's small order execution system where the NASD had to expand its prohibitions against professional investor usage because groups of traders dressed in investors' clothing were employing the system to pick off market maker quotes after any significant news announcement in a NASDAQ stock.

Automated systems also reduce institutional flexibility. Many institutions sometimes choose to work orders passively down on an exchange floor, sharing orders with the specialist and not disclosing the size of their interest. Systems featuring automatic executions at least complicate this strategy.

There are, of course, many professional users who find supplementary automatic execution systems extremely valuable. Certain institutions, Battery March and CALPERS come particularly to mind, prefer to display their buy and sell interest through such systems thereby avoiding paying the dealer spread. Similarly, many relationship traders and arbitrageurs find the ability to receive an instantaneous and assured execution valuable to successful implementation of their trading strategies. Finally, systems such as Instinet provide an extremely valuable means of advertising and receiving executions of large sized block orders. For the reasons discussed above, however, I would expect these systems to continue to play a supplementary role during home market trading hours.

My questioning of predictions of a brave new trading world is not to suggest, however, that there are not new initiatives which should be pursued by the U.S. securities markets.

First, incremental changes should be made in the existing U.S. markets. As I indicated earlier, the NYSE has in place floor wide electronic limit order books. These systems have substantially increased the efficiency of the exchange by permitting upstairs firms to send orders directly to the book. New York's limit order system also provides, however, an untapped opportunity to publicly disseminate limit order information. While limit order information may not be

predictive of price movements during the trading day it certainly is useful at the opening when market order imbalances and limit order ranges are clearly material. Today, however, pre-opening order imbalance information is only disseminated on Expiration Friday. Even then, the information disseminated only describes market imbalances in fifty major NYSE stocks and is not dynamically updated. It is now technologically feasible to disseminate limit order and market order imbalance information daily. This information might serve, as it does on Expiration Friday, as a means to attract market professionals to offset buy and sell imbalances thus averting large price movements or trading halts. Indeed the NYSE has indicated that it is exploring providing additional pre-opening information through what it refers to as a "peek at the book." I welcome this initiative and believe it should be expanded to provide information vendors the maximum amount of commercially viable information.

In addition, the ITS participants should consider changes to ITS which would increase the certainty of customer order executions. During the October 1987 Market Break, delays in printing ITS commitments on the NYSE floor functionally closed ITS. While NYSE enhancements should ensure that a total breakdown is much less likely, the requirement of a response from the receiving market results in a period of up to one minute when an ITS public investor order is not assured an execution and is at risk of missing the market. As I discussed

earlier, permitting professional investors to automatically execute against market maker quotations may impose unacceptable risks. Regional specialists, however, consistently have been willing to guarantee quote based executions for public investor orders through their automated execution systems. There is no clear reason why these "informationless" ITS public customer orders should not also be guaranteed an immediate execution. Concerns over interaction with trading crowd orders could be addressed by providing a brief exposure period where the specialists could improve the execution price for the ITS customer order to reflect the market in the crowd.

Beyond these incremental changes, I believe that U.S. exchanges and the NASD should explore the development of supplemental market structures. In particular, I believe the opportunity for the development of after hours trading systems should be actively considered. Institutions may wish to effect transactions in securities after trading hours in the market for many reasons; because of news regarding the issuer or macroeconomic events, or because the trade involves one or more foreign parties. More recently portfolio or program trades have been effected after hours based on U.S. market closing prices for a wide variety of purposes including the avoidance of execution problems arising from the Commission's short sale rule and restrictions on upstairs negotiations of index futures trades.

These trades are currently booked in London or other foreign markets, not generally because the other side of the trade originated there, but because exchange off-board trading requirements do not permit members to effect such transactions in the U.S. off an exchange and no U.S. exchange is open to accept the trade. This trading, while only a small percentage of U.S. daily trading volume can be significant. For example, in recent months program trading effected by U.S. firms in London has accounted for between 10 and 20% of all program trading effected by NYSE member firms. In one sense, these orders continue to be executed by U.S. firms and therefore the competitive input is minimal. At the same time, these trades are never reported and no U.S. interest has an opportunity to interact with them. Accordingly, the absence of U.S. after hours trading would appear to impact adversely market efficiency.

Fortunately, the markets are beginning to move to fill this void. The Midwest Stock Exchange recently has proposed an after hours portfolio trading system and the NYSE has proposed to allow the crossing of portfolio trades for thirty minutes after their 4:00 p.m. close. Similarly the CBOE and the NASD have announced their intentions to develop after hours trading systems.

Existing Electronic trading systems offer useful analogies as to how U.S. markets might better respond to the need for liquidity during after-hours periods. Systems such as the

Toronto Stock Exchange's CATS, the Tokyo Stock Exchange's CORE, Instinet, NSTS and the Chicago Mercantile Exchange's Globex, provide an environment where quotations and orders can be inserted and where transactions can be effected automatically in the system. It may be that automated systems offer greater utility for the sporadic trading which occurs after hours when continuous quotations by market makers are not required. Such systems permit the exposure to contra party interest of individual and program orders, thus increasing the possibility that they might be executed at superior prices.

I certainly don't pretend to have the expertise to say whether the development of after-hours systems would be successful in recapturing after-hours trading volume in U.S. securities or encouraging the trading in foreign securities in the U.S. But I do believe that this is an area that deserves serious attention from the major U.S. securities markets. Regulatory restrictions that impede the development of such systems also deserve to be carefully examined.

A second new market and systems opportunity relates to the trading of private placements. While U.S. securities exchanges and NASDAQ do provide liquid trading markets for a wide variety of registered foreign securities, securities of many other significant foreign issuers are not publicly offered or traded on an organized U.S. market because of the unwillingness of those issuers to comply with U.S. periodic reporting requirements. As most of you know, however, the Commission's

proposed Rule 144A would permit the initial sale and trading of private placements of foreign and domestic unregistered securities among certain institutions without the present cumbersome secondary trading restrictions now imposed. If the Commission adopts some form of Rule 144A, I believe it will provide U.S. underwriters substantial new opportunities to participate in international offerings. The anticipated increase in private placements of foreign securities combined with reduced trading restrictions also will offer the opportunity for active secondary markets in private placements. In turn, this provides new opportunities for the development of automated systems to facilitate such trading. In response, the NASD and American Stock Exchange have proposed the creation of systems, Portal and Situs, respectively, which would combine a quotation mechanism with a controlled clearance and settlement system intended to ensure compliance with Rule 144A. I believe these systems potentially may result in a new and dramatically improved market for private placements in the U.S.

Finally, as I suggested earlier, I believe shifts in institutional trading strategies have placed new demands on the markets. As a result of the increased popularity of passive investment strategies coupled with the embrace of broad tactical asset strategies, many institutional investors today choose to trade portfolios as opposed to individual securities. In turn, increased portfolio trading has imposed new order flow pressures on specialists which they are not able effectively to

respond to during volatile market periods. Yet because of the size of the program orders and the numbers of stocks involved, block positioning firms are not employing their capital to cushion the blow on the market of those orders.

The Commission has suggested that the development of market basket trading might help address this concern. Specifically, the Market Regulation Division's October Market Break Report encouraged the establishment of a market basket trading system which would permit trades in standardized market portfolios to occur in a single transaction rather than in multiple transactions spread throughout the trading floor. It was our hope that market basket trading might sufficiently increase the efficiency and decrease the risks of portfolio trading that member firms might be willing to employ their capital in positioning their customers' trades. I am pleased to note that both the New York Stock Exchange and the Chicago Board Options Exchange have indicated that they are exploring the many complexities involved in developing market basket trading.

Of particular note, however, is the system the NYSE proposes to employ to trade baskets. The NYSE proposal envisions a melding of a screen based system with both on-floor and off-floor market makers. Major integrated firms will be encouraged to act as market makers and will be permitted to enter both principal and agency orders into the automated system from their upstairs trading desks. In addition, the

NYSE proposal envisions well-capitalized firms acting as downstairs market makers in the basket as well as providing a collective guarantee by the specialists of the individual securities of an execution at the "corner" index price (e.g. the mathematical calculation of the aggregate bid and offer price of all the securities composing the index). By providing major firms with the flexibility of participating both upstairs and downstairs in trading the basket product, the NYSE may succeed in focusing the market making capital necessary to provide liquidity in a separate basket market. While the merits of any particular design of a basket trading system remain to be tested, I continue to believe that experimentation in this area is desirable.

In summary, the Commission's role has been and should remain primarily that of removing barriers to competition and preserving an environment where new trading products and systems may develop as the market demands them. Moreover, I believe there are important opportunities today for the development of new supplementary markets in the U.S. and for the development of innovative trading systems to facilitate trading in those markets. In large part, U.S. exchanges and the NASD are responding to these opportunities and the primary job of the Commission will be to allow these systems to get in place as quickly as possible. Nevertheless, if swift progress is not made towards meeting these challenges the responsibility

will fall to the Commission to remove any barriers that may exist in their development.