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(202) 272-2650



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The Securities Industry in 1985
Excellence Amidst Challenges

Aulana L. Peters
Commissioner

THE SECURITIES INDUSTRY IN 1985 -
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I am very pleased to have the opportunity to address this gathering of the Securities Industry Association. As the newest Commissioner at the SEC, I am honored to have been invited to speak to you today, an invitation that gives me the opportunity to get to know you better.

At the outset of my remarks, I especially want to congratulate the securities industry for handling successfully the exceptional conditions of the past year. You deserve praise for automating your operations so that you could easily handle 200 million share trading days and for providing continued liquidity in the markets during the unfavorable market conditions of 1984.

While the pace of initial public offerings and the boom in trading volume has slowed somewhat, the pace of change in the securities industry generally has accelerated. The securities markets themselves, both primary and secondary, are changing under the pressure of increased competition, new distribution techniques, and widespread use of automation. At the same time, the industry's genius for developing new security products continues, bringing an ever wider array of types of securities into the markets.

These changes and the pace of change creates challenges for the Commission, as it tries to stay abreast of new developments in the markets. In responding to these developments, the Commission is faced with the difficult task of balancing the opportunities for and the reality of competition and innovation with its fundamental goal of protecting investors.

Changes in market conditions also raise challenges for the securities industry, challenges that are multifaceted and complex. While I can't cover all these varied challenges in my time with you today, I would like to discuss three areas in particular which I believe will require a thoughtful and innovative approach by the securities industry and the Commission in the coming year. These areas are: developments in the options markets and their impact on market structure, internationalization of the securities markets, and the challenges of maintaining adequate supervisory and investor protection standards while improving the cost efficiency of broker-dealer operations.

OPTIONS AND MARKET STRUCTURE

From my newcomer's vantage point, the waters of the options markets appear to be in constant turmoil. This impression has been reenforced by my recent firsthand experience in viewing the rather frantic trading in options pits. Whether it be the extraordinary success of stock index and other new options products or the proposals of new markets to enter the fray, the options markets are constantly in flux, presenting the Commission with one interesting albeit difficult issue after another.

Of the many developments in the options markets, two issues in particular deserve discussion: the NYSE proposal to trade options on individual listed stocks, the NASD and exchange proposals to trade standardized options on OTC issues. The NYSE proposal recognizes changes that have already occurred in our markets and the NASDAQ options proposal would result in a structural change.

I would like to digress for a minute and explore the topic of structural change. As you know, for the last decade, the structure of the markets has been changing. Beginning as far back as 1971, the Commission and the securities industry began to recognize the need for greater market integration in the face of increased institutional trading activity in the third market and on regional exchanges. Together, the Commission and the industry began a series of initiatives to enhance the structure and performance of the various marketplaces. The Commission's course was confirmed by the Congressional directive in 1975 to help develop a National Market System to be characterized by market integration and fair and efficient execution of trades.

Plainly put, the Commission's mandate is to facilitate the elimination of artificial barriers to competition. Although the SEC has had to prod the industry towards the the National Market System on occasion, I think you will agree that the structural changes achieved so far have been beneficial. Certain basic market features, such as ITS, have become accepted as fundamental to the National Market System.

Most recently the Commission has amended the standards for National Market System designated securities so as to increase the number of NASDAQ listed stocks which are NMS eligible. In the release reporting this action, the Commission reiterated its intent to include NMS securities in other NMS initiatives. Thus, we requested comment on allowing exchanges to trade NMS securities in competition with the OTC market through the grant of unlisted trading privileges. The Commission recognizes that unlisted trading privileges for OTC securities raises the possibility that trading patterns in these securities could change. Nevertheless, the Commission felt that the potential for new intermarket competition in these stocks makes consideration of this issue worthwhile. That is what the NYSE and NASDAQ options proposal are all about in my view, intermarket competition.

The NYSE has proposed to trade options on listed stocks. It made a similar proposal in 1977 which contemplated NYSE trading of options on stocks which were already the subject of options trading on other exchanges (so-called "multiple trading"). The 1977 proposal would have also permitted trading of the stock and option at the same trading post by the same specialist (so called "side-by-side" trading). These aspects of the 1977 proposal, in particular, gave rise to serious questions about the NYSE entry into the options market, which were discussed by Commission staff in its 1978 Options Study.

The current NYSE proposal attempts to address a number of the concerns raised in the Options Study by, among other things, prohibiting both multiple and side-by-side trading and by calling only for NYSE participation in the Allocation Plan.

The time is right for consideration of the NYSE proposal. I share the concerns raised by commentators regarding the potential for misuse of market information and manipulation when the primary market for the stock begins trading the options. At the same time, I also am conscious of the 1975 Act's mandate to, where possible, increase competition among markets. The Commission will consider these issues very carefully.

The NYSE and its managers must be bemused by the irony of the fact that their sanitized proposal to trade options is being considered by the Commission at the same time it is considering a proposal raising side-by-side and multiple trading issues. These are proposals by the NASD and six different exchanges to trade options on OTC stocks and indices based on OTC stocks. The NASD proposal not only would establish OTC markets for standardized options for the first time; it also would permit side-by-side market making, where the same firm would make markets simultaneously in the same location in both the option and the underlying stock. The NASD proposes to permit side-by-side market making only when certain conditions exist, including the presence of a minimum number of market makers in both the stock and the option. The NASD believes that side-by-side trading is an integral part of its total proposal, and argues that the OTC standardized options

market will not be viable if integrated market making is not permitted. This portion of the NASD proposal generated more comment, both positive and negative, than any other single feature of the NASD's proposed options program.

The NASD proposal, by bringing standardized options to the OTC market and by providing for side-by-side market making, would create an entirely new trading environment for standardized options. In other words, it would result in a structural change in the markets. In reviewing the NASD's proposal, then, the Commission's central task will be to determine whether this new trading environment is consistent with the maintenance of fair and orderly markets and the protection of investors.

The exchanges' OTC options proposals in some respects are simpler to evaluate than the NASD's proposal, but in other ways raise extremely difficult policy and legal questions of their own. At an initial glance, these proposals simply would make a new group of stocks eligible to underlie exchange-traded options; However, the coincidence of the exchanges' and the NASD's proposals to trade options on OTC stocks requires the Commission to decide whether or not to allow the multiple trading of options on OTC stocks.

Of course, there is precedent for the multiple trading of options since it now occurs with respect to debt instruments and stock indices, but since 1978 the Commission has not approved the multiple trading of options on individual listed stocks. Instead, the Commission has permitted the exchanges to allocate among themselves exclusive rights to options on any particular

listed stocks. While this action took place long before my time, it appears to have been motivated by concern over the effects of multiple trading on the existing options and securities market structure.

A somewhat related concern involves the timing of Commission authorization of the NASD and exchanges to trade OTC options. While the NASD must develop a variety of wholly new systems to accommodate OTC options trading, the exchanges would be faced with relatively few operational obstacles to commencing OTC options trading. The Commission historically has been adverse to delaying implementation of new product developments beyond the time necessary for the industry and the public to prepare for their introduction. However, given the tendency of the first established market in a new product to prevail over subsequent markets seeking to trade the same instruments, the competitive implications of the Commission's decisions on timing could be significant. Many comments both pro and con have been received on these questions. If you have not voiced your opinion, you should do so. The Commission will have to consider carefully these persistent, and at times, perplexing issues in its review of the various proposals to trade options on OTC stocks. I think we would benefit from the expression of as many views as possible from as many sources as possible.

I would like to comment on one final options related issue which is currently before the Commission. On October 31, 1984, the Commission instituted disapproval proceedings regarding two proposed rule changes concerning the CBOE. The first proposal

would allow a plurality of floor members to elect the Chairman of the Executive Committee if more than one candidate applies for the position. The second proposal would increase the CBOE Board from 21 to 24 by adding three new floor directors.

I believe both of these proposals raise fundamental questions regarding the nature of self-regulation, which may go beyond the resolution of an internal dispute at the CBOE. For example, would the approval of these proposals set a precedent for greater floor control of all the exchanges, and thus reverse the trend of the past decade of having balanced boards of directors? As many of you will recall, the 1971 Martin Report raised these same issues and the NYSE ultimately adopted a so-called balanced board; that is, an equal division of public and member directors on the Board. Moreover, while I have not formed any final views on either proposal, I do think that the first mentioned proposal (i.e., the election of the Chairman of an Executive Committee by floor members) if adopted may set the stage for divisiveness on the Board. A power struggle is the last thing the CBOE needs during this period of intense change and uncertainty. Each proposal deserves your consideration and comment before the close of the comment period on December 31.

INTERNATIONALIZATION

Just as the waves of uncertainty raised by the Commission's National Market System initiatives have begun to subside, a flood of major proportions has begun to arise in the international arena. Foreign trading of U.S. securities has increased dramatically in recent years. At the same time, the U.S.

increasingly has become a major trading arena for the stock of foreign corporations: for instance, Schlumberger Ltd. and Sony were among the most active stocks on the New York Stock Exchange in 1983.

This trend towards international trading in "world class securities" has resulted in conditions remarkably similar to those in the U.S. securities markets in the early 1970s. For instance, trades in major stocks occur on a global basis without any central source of information about this trading; as a result, the full pattern of trading is known only to a few industry professionals with worldwide connections. Similarly, direct links between international equity markets trading the same securities have not yet been devised, with the exception of the Boston Stock Exchange's proposed link with the Montreal Stock Exchange. Communication ties between U.S. broker-dealers and foreign markets remain in an undeveloped stage. These inadequate conditions are perpetuated by the absence of a single regulatory authority over these worldwide markets; instead, there are numerous national regulatory bodies with disparate grants of authority and differing regulatory philosophies.

You can relax. I am not going to suggest that the SEC become a supra-national regulatory agency. Nevertheless, the Commission is interested in working with other national regulatory authorities to improve the structure of the international markets, harmonize securities regulations, and assure fair application of our securities laws to entities using U.S. markets. In my view, the Commission

has a dual challenge as our financial markets become more international. It must facilitate entry by foreign investors and issuers while guarding our markets integrity and liquidity. In order to meet the first challenge, we may be forced to modify and, in the view of some, perhaps decrease regulation to accommodate the newcomers. Of course, if we lighten the regulatory burden, in my opinion we must increase our enforcement efforts to make sure the rules we have are obeyed.

With regard to the last point, we are gradually overcoming some of the stumbling blocks encountered when insiders hide behind foreign secrecy and blocking laws. Secrecy statutes protect private interests in bank records abroad, such as the identity of a bank customer. Blocking laws protect a national interest by prohibiting the disclosure, copying, inspecting or removal of documents located in the territory of the enacting state. In 1982, the Commission entered into an agreement with the Swiss government. The SEC/Swiss Accord fosters cooperation between the United States and Switzerland by virtue of the exchange of law enforcement information when the conduct being investigated is violative of the laws of both countries.

Furthermore, in July, 1984 the Commission sought public comment concerning a proposal to implement a "Waiver by Conduct" concept as a possible response to problems created by foreign laws. Under this novel concept, the purchase or sale of securities in the U.S. would constitute an implied consent to the disclosure of information and evidence relevant to the transaction for purposes of any Commission investigation or legal action. If

this concept is adopted eventually, it is my hope that it will break down one more wall behind which insiders have been able to hide in the past.

The industry is already reacting to the trend towards international trading in a variety of ways. Some trading markets have considered expanding their trading hours; many larger firms are forming branches and affiliations in foreign countries; and some firms make over-the-counter markets in major stocks around the clock and around the globe. As the movement towards international trading of securities continues, however, the securities industry increasingly will face challenges in providing excellence in customer service while adapting to kaleidoscopic market structure conditions throughout the evolving global markets. Much of this may not be an immediate problem for many of you, as it is not for the Commission. But the time to prepare is now. I believe the SIA could provide a major service by acting as a focal point for discussion of the ramifications of and planning for further internationalization of trading. I recommend that you consider forming a committee to address these issues, and I pledge my (and the Commission's) willingness to support your efforts in that regard.

Productivity and Maintaining Effective Internal Controls

However the Commission addresses the regulatory problems before it and the questions raised by the internationalization of trading, one thing remains clear--the ever-increasing complexity of the securities markets highlights and underscores the need for an effective self-regulatory structure. The efforts

of the exchanges and the NASD to meet their market surveillance and firm compliance obligations has never been more important. However, the first line of defense remains the brokerage firms themselves. We cannot respond to the demand for efficient and unburdensome regulation and still protect investors unless the industry shoulders a greater responsibility in this area.

In that vein, I would like to discuss one more challenge that I believe the securities industry faces today -- that is to continue to encourage greater productivity without sacrificing effective internal controls.

A recent SIA study revealed that the financial performance of most brokerage firms for the first six months of this year, as measured by return on equity, was the lowest in a decade. In response to these financial results, firms are taking a number of cost-containment and cost-saving measures. In addition to internal reorganizations and restructurings -- and outright layoffs -- firms are trying to increase productivity per employee. These measures are being taken, I fear, without due regard for possible unintended effects. For example, recently firms have introduced compensation plans for registered representatives that skew the payout in favor of the "big producer" and penalize those who fail to produce above a certain minimum level of commissions.

Typically, a registered representative's compensation is a percentage of the gross commissions he or she brings in. These payouts have always increased incrementally with the amount of commissions earned. Recently, however, firms have lowered payouts for those at the low end of the commission production

scale while maintaining the same payout schedules for those at the scale's upper end. For example, I understand that brokers producing less than \$100,000 in gross commissions a year at one major firm now receive a payout of 25% of those commissions rather than the 34% earned previously, and those at another firm now earn 30% rather than 37% of gross commissions. Further, it has been rumored that experienced brokers at certain firms who fail to meet minimum production levels, such as \$250,000 in gross commissions per year, are subject to being fired.

I recognize, and am sympathetic to, the securities industry's need to reassess compensation given the rising costs and decreasing revenues in the industry today. Nevertheless, I am concerned that this type of pressure to improve productivity among your salesmen may also provide incentives to relax the supervisory controls that are in place. Management may scrutinize less carefully, or even ignore, the trading activity of those "big producers" or those who are struggling to meet their "production" quotas. This environment provides greater opportunity for sales practice abuses and, in fact, may encourage it.

While a sound system of supervisory controls is important to the success of any profit-making organization, it is particularly critical to the securities industry where customers rely on a firm's integrity when they hand over their savings for investment. A breakdown in these controls may result not only in monetary loss to the customer and the firm, but a loss in the integrity of the firm, the industry, and the market as a whole. As such it is necessary for the Commission and the self-regulatory organizations,

through their enforcement programs, to remind firms of the continuing duty to supervise their employees. Hence, at the same time that firms are reexamining their compensation structures, it is at least as important that they reassess the effectiveness of their supervisory controls, for example, by scrutinizing registered representatives who are close to a breakpoint in their compensation grids and those "big producers." In addition, more frequent reviews of branch offices might be appropriate. I am confident that you will be able to meet this challenge to maintain the soundness of your supervisory control systems.

CONCLUSION

In all, the securities industry has done a commendable job of responding to the trying conditions that have confronted it in the past year. Foresight and planning have enabled you to ride out the surges of volume and changing conditions that have buffeted the market. It is in that spirit that I bring to your attention some of the areas of challenge that I see confronting the securities industry, so that once again you will be prepared to respond successfully to developing situations, whatever they may be. In this way, I expect the securities industry will continue to maintain its enviable record of providing excellence of service amidst the most challenging of conditions.