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"THE CENTRAL MARKET SYSTEM"

ADDRESS BY

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THE CENTRAL MARKET SYSTEM

At a time of considerable uncertainty as to where we are going and how we are going to get there, the idea of creating a central market system has met with a surprising degree of general acceptance. Most segments of the industry seem to favor it, the Committees of Congress having jurisdiction over the securities markets support it, and the Commission is committed to its development. This unanimity is all the more intriguing since no one yet knows exactly what it will be like.

I wish, this evening, to talk with you about the central market system, what it generally involves, why we need it, and some of the questions to be faced along the way.

The idea of a central market system has been developing over several years. The Commission's letter of March 10, 1971, transmitting the Institutional Investor Study to the Congress contained the germ of the idea. It said:

> "A major goal and ideal of the securities markets and the securities industry has been the creation of a strong central market system for securities of national importance, in which all buying and selling interest in these securities could participate and be represented under a competitive regime."

Since then The Martin Report of August 5, 1971 to the New York Stock Exchange, the Commission's Statement of February 2, 1972 on the Future Structure of the Securities Markets, and the Commission's Statement of March 29, 1973 on the Structure of a Central Market System have further developed the concept. A particularly important discussion is found in the Statement on Public Policy for American Capital Markets prepared by Professor James H. Lorie and issued by the Treasury Department on February 7, 1974.

Perhaps the most significant aspect of these discussions is that they define a process not an institution. That, presumably, is why we refer to a central market <u>system</u>, not simply to a central market. It is not to be a building located somewhere, nor will it, at least initially, be an organization springing full-blown from the brow of its creators, although that may ultimately evolve. Rather, it is a mechanism by which investors everywhere may have their orders executed in a more efficient way, and hopefully at lower cost and with better prices, and where all the resources of the securities community may be brought to bear to provide fair and orderly markets with depth and liquidity, as well as the benefits of competition.

Essentially, the Central Market System is visualized as a national system of electronic communications linking all markets together, governed by uniform rules to the extent necessary and supplemented by a national system for clearing and settlement including a national depository system to immobilize stock certificates. The securities to be traded will be those listed on the major exchanges and other listed securities for which a national market is feasible. The principal elements are the consolidated tape, the consolidated quotation system, a unified electronic "book" for limit orders and clearing and settlement systems together with necessary uniform rules.

The consolidated tape is well on its way. A plan for bringing this about was filed with the Commission by the principal exchanges and the NASD under Rule 17a-15 earlier this month. After an initial development period of 20 weeks, and a pilot period of 20 weeks, it is expected to become operational early next year.

The consolidated quotation system is next. This will collect and display the current quotations of specialists and other market makers in the securities in the system.

The NASDAQ system of the NASD provides a model as to how this can work, at least mechanically. We expect that the staff will provide us with recommendations in further detail on this subject, hopefully next week. Among the questions to be dealt with are eligibility standards for market makers, the provision of data concerning the size of the markets, and the mechanics of transmitting orders.

A national book will be needed in which limit orders can be entered. This will be available to all specialists, and the orders on the book will have to be taken care of in connection with the execution of transactions essentially as is now done on the principal exchanges. This will insure that limit orders will not miss an opportunity for execution simply because a transaction occurs on a market other than the one on which they were entered, and will thus aid in the protection of the auction market. Whether this book will be open to brokers other than specialists will be determined in the light of experience.

The industry is now in the process of developing a national system for clearing and settlement. This will necessarily include the use of depositories. While this system is needed independently of the central market system it is, of course, essential to that system. The principal open question is whether there will be one system or a number of systems with a full interface. I would hope that it would be possible to preserve opportunities for experiment and local initiative before settling on a final approach.

It is agreed that certain uniform rules should be in effect in all markets by the time the consolidated tape is operational. These include rules on short selling and rules on manipulation. Proposed short selling rules have already been published for comment. We are considering whether the short selling rules can be improved. The existing rules, which have been in effect for more than 20 years, depend for their operation on a "tick" test bесed on whether the next proceeding different tick was an up tick or a down tick. We think that it might be possible to develop a less mechanical standard. With respect to manipulation, this is prohibited already by the Securities Exchange Act as well as by more specific exchange rules. Based on this experience, I do not anticipate any serious difficulty in developing an appropriate uniform rule on this subject.

Before the central market system is operational, we will also need rules protecting public orders in the national book and also rules giving preference to public orders over bids or offers by market makers and other participants in the system acting as principal. These two rules, which are described in more detail in our policy statement of March 29, 1973, are designed to preserve the auction agency market.

You will no doubt observe that the foregoing is not a detailed blueprint for the central market system, rather it is an outline sketch. A good deal remains to be worked out. I will return to this point but first I would like to indicate why I believe the whole central market exercise is necessary.

One could easily say that we have a good market now, the best in the world, so why change it. You can, I think, see one reason for change, the market is not going as smoothly as it used to. This has happened because important economic forces are at work. The principal change is the increasing presence in the market of financial institutions. Institutions now account for about 70% of public dollar volume on the New York Stock Exchange as compared with about 34% as recently as 1961. Institutions buy and sell in large volume, often in blocks. Moreover, it seems that institutions have some tendancy to be on the same side of the market at a given time. This has placed a severe strain on markets designed to handle smoothly a reasonably steady flow of 100 or 200 share orders, normally on both sides.

The problem of institutional trading has been aggrevated by fixed commission rates. Institutions are concerned about the commissions they pay, since the dollars involved in a large order are significant. Individuals are not so much concerned about rates and even when they are, there is not much they can do about it. Institutions can and have. They devised all kinds of schemes to avoid or evade the fixed commission. And they found brokers and regional exchanges which are prepared to cooperate in order to attract institutional business.

The net result of all this was a fragmentation of the markets, both internally and externally. New markets such as the third market appeared. At the same time institutional brokers emerged who were skilled in finding the other side of a large order and willing to position, if necessary. Their transactions might be nominally taken to the floor but were not really executed in the market there.

Fortunately, the technology necessary to meet these problems has been developed. It is no longer necessary, for lack of any other technically feasible method, to bring all orders together on one floor. A national market is a practicable alternative.

The demands on the market mechanism are greater than they used to be and there is no reason to believe that this trend will be reversed. Consequently, all of the market making capacity of the country needs to be mobilized to preserve liquidity and depth. It has never been easy to insure by regulation that market makers will do their job under stress. The long and somewhat checkered history of specialist regulation shows this. The Congressional studies and debates of 1933 and 1934 which led to the passage of the Securities Exchange Act, the Special Study of from 1961 to 1963 and the recent studies of the securities markets by the Senate Subcommittee on Securities and the House Subcommittee on Commerce and Finance all called for better specialist performance through better regulation.

It has been reasonably possible to restrain specialists from doing what they ought not to have done but it has been more difficult to prevent them from leaving undone what they ought to have done. I think the time has come to rely more on the forces of competition to discipline market makers' performance. The central market system will do this.

Thus, in outline we have the concept of the central market system and the reasons for it. How is it to be brought into being? I do not think it practical to identify in advance all problems and all needs and to set forth detailed solutions now. We will have to watch how things evolve within the basic concepts I have mentioned. In this task we look for major assistance from the new Advisory Committee on the Central Market System, headed by your own Sandy Yearley. This Committee has just been organized and will hold its first meeting this week. I will not attempt to predict what it or the Commission will do. But I would like, in closing, to touch upon a few major concerns and objectives. The first of these is the auction market.

There is agreement that the auction market should be preserved. This can be done, but in so doing it must be recognized that there is a need for strong dealers, too. The auction market and the dealer market are not alternatives. We need both and we have had both, through the specialist system, for many years. The essentials of the auction market in the central market system are the composite book for limit orders and rules giving priority to public orders over dealer orders everywhere in the system. Even so, we need more public orders. An auction works well only when there are a substantial number of participants making their bids and offers. This raises the question of how we bring the individual investor back into the market.

This, unfortunately, is not primarily a matter of market structure or regulatory policy, it is a matter of economics. A good market structure and effective regulation can certainly help, by creating and maintaining investor confidence that the market is fair, honest and efficient. Without these the individual surely will not come back. But even with them, he will not come unless he thinks the market is a good place to make money. A market which seems to go nowhere but down is not attractive. High interest rates make alternative investment media look good. And there is, I think, a need for tax policy which makes equity investment attractive. The Commission traditionally has neither authority nor responsibility nor expertise in the tax area. But I hope we can presume to point out what we see. For example, there has recently been a great proliferation of so called tax sheltered investments. These include real estate syndications, oil drilling deals, cattle feeding programs and what have you. No doubt many of them meet a public need. But as I see these offering go through the Commission, I observe that the intrinsic investment merit of some of them is extremely dubious. The lure is large tax deductions available whether or not the program ultimately makes a profit.

Another economic fact is the vast amount of capital which American industry will need to raise. The energy problem, the need to protect the environment without reducing our standard of living, and to modernize plants in the light of technological advance and world wide competition all require unprecedented amounts of capital.

Providing it is a national priority of a high order. To meet this need two things, among others, are called for, secondary markets which can do their part and a healthy securities industry.

I can assure you that the Commission is concerned about the state of the industry. This is true not so much because you are our industry and we therefore have the parochial concern for your interests of which regulatory agencies are commonly accused, it rather is true because you are an essential industry which must be able to perform its function. We would like to do what we can to help and solicit your suggestions. The difficulty is that your problems are basically the result of economic developments, some of which I have mentioned, and not of regulatory decisions. So, in large measure, you will have to help yourselves, as businessmen always have. I would venture an admonition. Restraints on competition, and a resulting effort on the part of some in the industry to carve out protected preserves from which others in the industry are excluded, are not the way out. Rather, this leads to divisions and bickering which impair the ability of the industry, to unite in meeting its problems. The national need for more capital confronts you with a challenge and provides you with an opportunity. You and we must work together to meet the challenge and take advantage of the opportunity. Creating the central market system is a part of that effort.