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SEC SECURITIES INDUSTRY HEARING OPENS WITH SUPPORT FOR COMPOSITE TAPE, MORE COMPETITION, FAIR REGULATION

The need for a composite tape consistently reporting prices, volumes, and quotations in all markets, competition between exchanges and between markets, and a fairer regulation of exchanges and markets was repeatedly voiced by witnesses at the opening session of the SEC's public investigatory hearing. Other frequently sounded themes related to the issues of institutional membership and competitive rates. The hearing was called to "determine what changes are needed in the rules under which registered exchanges and other securities markets Operate," see SRLR No. 116, Page H-1, and is expected to continue for at least one month.

Composite Tape Increased Communication

Milton H. Cohen, formerly Director of the SEC Special Study of Securities Markets, and presently general counsel of the Midwest Stock Exchange, was the lead-off witness on the first day of the hearing. Speaking before Chairman Casey, Commissioners Needham and Loomis, a large assembly of staff officials, and a larger group of industry representatives, Mr. Cohen called for the development of a "national market system, provided the emphasis is on 'system' rather than any 'single' market." As part of this system, he envisioned "strong channels of communication" so that "all recognized market-makers in an issue will have access" to the entire flow of orders and to current market information. This means, he explained, that the market-maker who provided the best execution of an order would "see" it and have an opportunity to fill it. Also, the current bids and offers of all market-makers would be available to each other and to qualified brokers. In connection with this, the specialist's book of limit orders "should be made available in some fashion to all recognized market-makers.

Prices, volumes, and quotations in all markets should be compositely and consistently reported, according to Mr. Cohen. Without obscuring the location or nature of particular trades, he added, all trade data should be brought into an integrated display system. In addition, whatever types of trade data are thought to be worthy of dissemination, "should be provided with respect to all competing markets and market-makers." Support for a composite tape was echoed by John C. Whitehead, a partner of Goldman, Sachs & Co. and former chairman of the Advisory Committee of the SEC's Institutional Investor Study. Mr. Whitefield called for the cooperation of "all segments of the industry" to achieve promptly a composite tape such that "every transaction in a listed stock, whether executed on any of the exchanges or in the over-the-counter market, is reported promptly and publicly for all to see."

Seymour Smidt, formerly Associate Director (Markets) of the Institutional Investor Study and presently a professor of managerial economics at Cornell University's School of Business and Public Administration, declared that the wide and prompt dissemination of information about the prices and volumes of completed trades, and about the bids and offers of qualified market makers, "is necessary to the efficient operation of a central market." The SEC, he said, "should require that each self-regulatory authority collect, on a real-time basis, information on current transactions that take place under their respective jurisdictions." The information so collected "should be made available on a non-discriminatory basis to interested parties, including firms who are in the business of disseminating it."

NASDAQ

A strong central market, according to professor Smidt, also requires wide dissemination of information about bids and offers. Therefore, he recommended that the "Commission review its rules and procedures and those of the exchanges and self-regulatory agencies under its jurisdiction, with the objective of eliminating any barriers . . . that prevent recognized market-makers from publicizing their current quotations in NASDAQ." Such a communication system "should be expanded to include not only the price, but the depth the market-maker is prepared to guarantee for each bid and offer."

Supporting professor Smidt' s recommendation for increased utilization of NASDAQ, Donald M. Feuerstein, formerly Associate Chief Counsel (Markets) of the Institutional Investor Study and now counsel to SalomonBrothers, said that all market-makers, including stock exchange specialists, "should be required to input their quotations into the system." Such a step, he declared, "is possible almost immediately, [and] should be accompanied by the development of a combined tape to report all listed stock transactions." Since the composite tape should encompass all markets for listed securities, "it should be supervised by the Commission."

Increased Competition

Even the most perfect and complete concentration of orders in the hands of a single market-maker "would not do for most stocks today," declared Mr. Cohen. What is needed to sustain continuous, liquid markets in most stocks, in addition to a strong flow of orders, "is more quantity and quality in market-making . . . which . . . means competing market makers." The ultimate worth of a national market system will depend, in Mr. Cohen's opinion, "on whether it fosters the needed enhancement of competitive market-making." When two specialists have the same issue in the same market, "they are subject to the same economic and regulatory stimuli and, with little to choose between them, there is a tendency for members simply to divide the business between them." On the other hand, when two market-makers are in different business or geographical groupings and under different self-regulatory regimes, "they are likely to become mutually challenging and competitive in a quite different sense." After all, Mr. Cohen noted, competition between Pontiac and Oldsmobile "can never be the same as between General Motors and Ford."

Uniform Regulation

Differing regulation of securities markets is not necessarily wrong, according to Mr. Feuerstein, as regulation that is required in the primary market for a security may not be required in other less important markets. Each instance of unequal regulation “should be examined individually.” So long as competing markets are allowed to exist, “their administrators must be given some individual discretion in the performance of their regulatory functions.” There is more reason to accept differences in regulation arising from variation in the exercise of self-regulatory power by separate markets than from unequal rules imposed by the Commission, he concluded.

Mr. Whitehead and Mr. Cohen differed somewhat in their approach to the issue of unequal regulation. Mr. Whitehead asked that uniform rules be established for all exchanges. It is certainly not in the public interest, he declared, “for transactions to be executed on one exchange solely because the rules of another exchange do not permit it to be done on the first one.” Mr. Cohen took a more middle ground. In his view, “universal regulatory standards are essential in areas involving market integrity and protection against manipulation, deception, misappropriation, or overreaching.” But, on the other hand, “uniformity is not to be sought for its own sake.”

Purely economic and purely operational matters “may generally be left to competition, subject always to the paramount concern to maintain a fair field of competition.” Where uniform or substantially uniform regulations are called for, though, “they may be either imposed by laws or Commission rules or assured through Commission oversight of self-regulatory rules -- not, of course, by any one self-regulatory agency imposing its notion of uniformity on others.”

Institutional Membership -- Competitive Rates

The issues of institutional membership and competitive rates were generally considered in the context of their interrelationship. Mr. Whitehead called for a move toward competitive rates on all orders, “but this should be done gradually and carefully over a period of several years so as not to seriously disrupt an industry that has had more than its share of disruptions in recent years.” He also said that the elimination of fixed commission rates “will largely remove the economic incentive for any institution to join an exchange for the purpose of recovering commissions and will substantially reduce the pressures from institutions to join exchanges “ To Mr. Feurstein, “fully negotiated rates for institutions are inevitable because of the inexorable economic forces that fixed minimum rates create.” In addition, the elimination of fixed minimum commissions for institutions “is a necessary precondition for institutional membership.” If a decision should be made to attempt to maintain fixed rates, “institutional membership should be prohibited on all stock exchanges.”

If the SEC “wishes to place increased reliance on the forces of competition to create a strong central stock market that is fair, efficient, and flexible,” according to Professor Smidt, “it is essential to move toward a system of competitively determined rates for brokerage commissions.” Non-competitive commission rates charged to institutions and brokers, he declared, “have led to complex anti-competitive reciprocal dealings, have exacerbated a wide variety of conflicts of interest, and by creating barriers between brokers-dealers, market-makers, and markets, have impeded the development of a strong central market." Furthermore, non-competitively determined fixed minimum commission rates between brokers and their public customers "provide unnecessary encouragement to the churning of customers' accounts, and discourage the development and application of less costly ways of servicing the public customer." There is a strong tendency for the level of costs to adjust itself to the brokerage rate schedule, he concluded, "since firms can attract customers from their competitors only by offering more service, even when the services cost more than they are worth to the customers."

The desirability of institutional membership was questioned with respect to the danger of institutions' "increasing dominance in the affairs of the exchanges themselves." An important issue for the SEC to consider, Mr. Cohen thus stressed, is "whether institutions are likely to become dominant in the governance of stock exchange or to gain undue advantages in trading, so that, for either of both reasons, markets will be less fair and orderly for the non-institutional investor." He wondered whether a larger role of institutions in formulating self-regulatory policies would result in "giving too high a priority to adapting markets to the needs of institutional trading, instead of conforming institutional trading to the requirements of markets that also, and perhaps primarily, serve non-institutional investors." Even in the rate area, he added, there might be a tendency in an institution dominated market to put "too heavy a burden of transaction costs on smaller investors and thereby affect the competitive balance."