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PRESERVING THE AUCTION MARKET - CORE OF THE CENTRAL MARKET SYSTEM DEBATE

I am particularly pleased to be here and would like to thank Bill Baughn for the invitation. I don't know if it was prescience on his part or just luck on mine, but I have been eager for an opportunity to discuss the projected central securities market with members of the banking industry.

It is especially important that you understand the issues underlying the various central market proposals that have been and will continue to be advanced, and that you participate in the dialogue. Not only do the ramifications affect your industry directly as transfer agents, registrars and trustees of some $200 billion in corporate stock, but damage to the securities markets would have almost certain repercussions for banking because of the complementary roles our two industries play as financial intermediaries.

While my bookshelves are groaning under the weight of the securities industry studies that have poured forth in recent years, I sometimes regret that the Hunt Commission did not include the securities industry in its study on financial structure and regulation. That would have emphasized the industry's role as a financial intermediary and its interconnection with banking and other financial industries which together comprise the financial market mosaic.

Unquestionably, impairment of the stock trading process and the accompanying damage to the economy's ability to deliver risk capital where it is needed would have a serious impact on bank loan and investment patterns. Narrowing the equity base would leave the banking industry with two choices: either to assume greater risk on loans, or to adopt more restrictive loan policies. Thus, as the central securities market discussions unfold, the resolution of the issues should be of more than casual or academic interest to you.

Unfortunately, when one is caught up in the rush of day-to-day business, he has little time for reflection on broader and less immediate problems. You have been fortunate in having the chance during each of the past three years at the Stonier School to step back for a fortnight from the daily pressures and to view your industry in broader perspective. Catching you in your waning minutes as academics, I hope I can give you something more to think about as you plunge back into the business pressure cooker.

The staff of the New York Stock Exchange is preparing a discussion paper which explores in depth the many issues affecting the structure of a central exchange market. This paper will probably be ready for consideration by our Board of Directors next month. Though it is still in preparation, I want to preview for you some of the major issues that the discussion paper will most certainly address.

PRESERVING THE AUCTION MARKET

In developing the Exchange's central market plan, the wide range of seemingly disparate issues are tied together with a single tread -- the need to preserve and enhance the auction market concept for trading stock. In addressing each issue, therefore, the first question tobe asked is: what implications does it have for the auction market?

The Exchange deems the preservation of a smoothly functioning auction market, which is the product of almost two centuries of development, as absolutely essential to the maintenance of the high quality of the U.S. capital markets. Our capital markets, admired as a model throughout the capitalist world, are distinguished from the dealer markets of other countries -- most conspicuously by the auction system of trading. These markets have provided the vehicle for millions of Americans to become stockholders and, thus, have given life and vitality to American business.

The great advantage of an auction market is that it affords direct interplay of buying and selling interests, thereby providing for the quickest possible adjustment to supply and demand factors. The alternative, dealer-dominated markets, are inherently less efficient because the forces of competition operate only indirectly. Each dealer's knowledge of the market in a given stock is necessarily extremely limited. In a dealer market, intuition and trial and error play a key role in the adjustment of supply and demand.

In addition, like any businessman, the dealer must be compensated for his inventory cost and the risk associated with carrying an inventory whose price is volatile. Thus, a dealer must buy lower than he sells -- the familiar bid-and-ask price spread. By contrast, an auction market permits the buyer and seller to trade directly at a price falling between the quotes, giving each the opportunity to obtain a better price. This is the basis for the assertion that exchange auction markets are inherently more efficient than dealer markets.

Also to be considered is that, unlike the public auction market, the dealer is not blind to whom he trades with. Like any businessman, he favors the best customer. Inevitably, that would accentuate the edge that institutions now have over individuals and would further aggravate what is recognized as a major stock market problem. By contrast, a central auction market would force greater interaction between all traders, thus restoring some balance between individuals and institutions.

WHY A CENTRAL MARKET?

Both from theory and practical experience, we know that the greater the flow of orders, or market depth, the greater the likelihood of making an auction market trade, the smaller the price movements between trades, and, in general, the better the quality of the market. That is why the concept of a central market has won wide support.

Currently, a given New York Stock Exchange listed stock may be traded not only on our floor, but in the over-the-counter market and on one or more regional stock exchanges as well. Fragmenting the total market in this manner detracts from overall stock market efficiency. This is one situation where the sum of the parts does not equal the whole and which a central exchange market may correct.

THE BASIC FRAMEWORK

To draw the now-fragmented exchange markets together, our plan will support a consolidated tape to report all transaction prices and volume, and a system of competing quotations to enable brokers to identify the best market for a customer's order at any given time. We firmly believe, however, that a framework of equal -- or at least similar -- regulation must be established before these innovations can be placed in operation. Once that has been done, these two elements, a composite tape and a competing quote system, would constitute the essential first step in developing a new central market. Under ideal circumstances, the non-exchange or third market would be integrated into the exchange market system.

Contrary to the claims of some third market dealers, this view does not signify a plot to force them into New York Stock Exchange membership. They would have the option of joining any of several exchanges which would be part of the central system. Many third market dealers, indeed, are already members of regional exchanges.

Given the prospect of fundamental changes in the securities industry, there is danger that the viability of the auction market system could be threatened by dealers catering primarily to institutions. That would not be in the best interest of the investing public or the basic fabric of the U.S. economy.

Why is it so important to integrate all of the now-fragmented markets in listed stocks into a single system? Let's examine some of the important related issues beginning with commission rates.

IMPLICATIONS OF NEGOTIATED COMMISSION RATES FOR MARKET STRUCTURE

In the clamor for eliminating the minimum commission rate schedule, proponents of rate competition have frequently overlooked the implications of such a move for the central exchange market system. If all rates are set competitively, what incentive will securities firms have to retain their exchange memberships -- to accept the burden and expenses of additional regulation without appropriate compensation?

Operating outside the central system, a broker-dealer could have the best of both worlds. He could act as dealer himself or trade with third market dealers at will -- or trade through the exchange system, when it suited him, at minimal cost.

With access to the exchange system readily available to all non-member broker-dealers, exchange members would be hard-pressed to justify the expenses of membership and would drift away, and the exchange system would lose depth. As depth dwindles, so does market quality -- in a process of accelerating erosion.

The end-result would be a withered auction market. And, ultimately, the purported savings attributed to rate negotiation could prove illusory -- with an efficient auction market system yielding to a far less efficient and more costly stock-trading mechanism.

These are the major reasons why the New York Stock Exchange has urged that when and if a move to fully competitive rates becomes practicable, there must be a companion requirement that all trading in listed stocks take place within the central exchange system.

REGULATORY CONSIDERATIONS

There has also been a good deal of discussion of the regulatory framework needed for a central exchange market. In essence, the market will be a communications system. But the installation of electronic gear alone does not make for a viable central market. The value of the most sophisticated communications network is limited by the reliability of the data that go into it. For example, if prices are not reported in proper sequence and with a minimal lapse of time after the trade, the usefulness of a tape is virtually negated. Effective rules are required to assure that all pertinent price and volume information are communicated on a timely basis. Unreliable data, tardily reported, would be valueless and probably harmful to investors.

Just as important, the various component exchanges of the central market system must have similar trading rules to assure high standards and efficiency. In the absence of such rules, a member wishing to circumvent a particular rule on one exchange could take his customers' trades to another exchange having lower standards -- and competition could develop on the basis of who has the most lenient rules, as much as on the basis of stock prices. The result could be a sort of Gresham's Law, with easier trading rules driving more stringent rules out of existence. Thus, a major objective of central market system planners must be to establish rules that will assure that the quest for the best price does not impair the maintenance of high operating and regulatory standards. This can best be accomplished through the development of appropriate uniform rules.

Additional regulatory complications would arise if the third market were not integrated into the exchange market system. Recognizing the importance of preserving auction market depth, the New York Stock Exchange has long relied upon its own Rule 394(b), which permits members to trade listed securities in the third market only in those situations where the third market offers the better price. If that rule were eliminated, as some have suggested, all exchange system members -- including our own -- could trade in the third market without first checking the auction markets. Some large brokers might find that so attractive that they would set up special dealer subsidiaries to execute their orders. Therefore, we believe that as long as the third market remains independent of the exchange system and subject to lesser regulatory standards, we must maintain effective precautions against the loss of auction market depth for reasons other than best price.

We are proposing to simplify the existing rule to ensure that the investor can get the best available price. But we also recognize that unless orders are funneled into a central exchange market, the benefits of being able to trade within the dealer spread -- that is, the benefits of auction trading -- will be eroded. Integration of all market makers into the central exchange system would establish that all trading of listed securities must take place within the system of exchange markets. When that has been accomplished, Rule 394(b) would become a nullity.

Another cause for special concern is the future of an Exchange rule which bars specialists from dealing directly with institutions in their specialty stocks. Third market dealers and regional exchanges have no comparable rule. The New York Stock Exchange's rule was originally adopted on the recommendation of the SEC because of the potential conflict of interest between the specialist's market-making activities and his responsibilities to his own public customers. The question posed by the SEC was, would the specialist favor his own customers over the customers of brokers who entrust their orders to him? The question was a fair one, and the fairest response was the development of our Rule 113 to eliminate the potential conflict.

How does this relate to the question of integrating the third market into the central exchange market system? Very simply, failure to bring the third market into the system would probably force specialists to balk at complying with a rule that would place them at a competitive disadvantage. Faced with competition from third market dealers who could trade directly with institutions, many specialists, understandably, would elect to leave the exchange system. On the other hand, if Rule 113 were abrogated, exchange member commission brokers would find themselves in competition with specialists for institutional business and might respond by setting up their own market-making operations in listed issues. With the third-market concept becoming increasingly attractive to exchange member firms, the incentive to exchange membership would be further undermined.

Clearly, if the third market is not integrated into the exchange market system, we will find ourselves on the horns of a dilemma. If Rule 113 were not abrogated, the specialist would have an incentive to leave the Exchange, thereby weakening the exchange market system. But if it were abrogated, brokers might be pushed into becoming dealers, undermining the auction market concept.

Finally, eliminating intermediation of brokers in favor of trading on a principal basis would have even more serious effects than subverting the auction market system to the detriment of individual investors. It would seriously threaten the survival of our basic system for raising capital and distributing securities through the branch office network of exchange member brokers which now spans the country.

I am firmly convinced that the potential dangers to the integrity of the auction market are so great that, with respect to Rule 113, the only possible solution, within the framework of a central market system, is to apply the rule system-wide as a means of reassuring the public about the impartiality of all market-makers within the system.

Although this has been a somewhat technical discussion, I think it can readily be seen that a central market system is really comprised of two essential elements -- the basic communications network and a set of rules to govern the conduct of trading and disclosure in the various markets. Just as important, the regulatory framework must be in place before the communications system becomes operational, even on a pilot basis. Exposing investors to innovative technology without effective, uniform regulatory safeguards could be confusing at best -- and extremely dangerous at worst.

Recognizing this, the Board of Directors of the New York Stock Exchange has decided that the Exchange should immediately begin working closely with other exchanges and the National Association of Securities Dealers to develop the essential regulatory philosophy.

A GAP IN SECURITIES REGULATION

Achieving uniformity in the regulation of securities trading reaches out beyond the securities industry itself. If regulatory safeguards are not to be breached, regulation has to be uniform and even-handed. In recent years, the number of potential regulatory escape routes has proliferated as financial institutions of every type have sought to diversify.

In your industry, for example, I am concerned about the recent initiation by several banks of plans whereby individuals can set aside modest amounts each month for stock investment. Monthly payments are deducted from the investor's checking account. While I would normally be the last one to complain about a plan that encourages individual investment in equities, I am concerned by the lack of regulatory safeguards.

New York Stock Exchange member firms trading for individuals must comply with rules regarding the suitability of investment recommendations. By contrast, banks signing up investors for their stock plans are not required to follow any guidelines whatever. I do not mean to suggest that there is any improper or unethical conduct by the banks that have initiated stock purchase plans. But if it is in the public interest to have investor safeguards at all, then it is only logical that similar standards should apply to similar types of activity wherever they are conducted.

Another area that disturbs me is the potential that diversification offers financial institutions for tie-in arrangements between basically different types of activities, whether it be in banking or other industry. Such practices artificially distort normal competition among providers of similar services.

My concern in this area does not exclude the securities industry.

Just as it would be unfair for banks to offset deposits against trust management fees, so it is often maintained that brokerage firms should not engage in the practice of offsetting brokerage fees generated by managed accounts against the management fee. The Exchange's Board of Directors is now reviewing that practice. Should the decision be to prohibit it, I would hope and urge that all other industries, including banking, would study our decision with a view to adopting a similar prohibition on any formal or informal fee offset arrangements they may have.

Lack of uniformity in regulation is a problem that not only cuts across industry lines, but spans the oceans as well. As you know, foreign banks operating in the U.S. have a competitive edge over U.S. banks in that they can operate across state lines. Perhaps less well known, foreign banks hold memberships on U.S. exchanges, which national law prohibits to our domestic banks. Until these and all other regulatory anomalies are done away with, there will remain an element of unfairness in competition among the various financial sectors.

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Despite many thorny problems and differences of opinions about solutions, the concept of a central exchange market is now on the way to becoming a reality. But with no models to guide us, drafting the blueprints is no easy proposition. Tentative decisions made today may be altered or even dropped tomorrow as the details of the central market become clearer. At this point, no one can say with any certainty what the ultimate shape of the central market system will be.

For me or anyone else to attempt to describe it would be only conjecture or, worse, wishful thinking. What I have tried to do is convey some of the problems that need resolution and some of the possible pitfalls. In dealing with them, I cannot emphasize strongly enough the need not only to preserve, but to strengthen the auction market system.

As you follow the development of the various central market issues, I hope you will ask, what implications does it have for the auction market? Any appreciable weakening of the auction trading system is bound to have repercussions on banking and the entire panoply of institutions which together comprise the U.S. financial market system.

Thank you.

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