SEC AUTHORITY OVER THIRD MARKET TRADING

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

ON

S. 3126

TO AMEND THE SECURITIES AND EXCHANGE ACT OF 1934 TO AUTHORIZE THE SECURITIES AND EXCHANGE COMMISSION TO PROHIBIT BROKERS OR DEALERS FROM TRADING LISTED SECURITIES OTHERWISE THAN ON NATIONAL SECURITIES EXCHANGES IN THE EVENT THE COMMISSION DETERMINES THAT SUCH TRADING IS CONTRARY TO THE PUBLIC INTEREST AND THE PROTECTION OF INVESTORS

MARCH 27 AND 28, 1974

Printed for the use of the
Committee on Banking, Housing and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
41-920 WASHINGTON : 1974

CONTENTS

SEC AUTHORITY OVER THIRD MARKET TRADING

WEDNESDAY, MARCH 27, 1974

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 1:30 p.m. in room 5302 of the Dirksen Senate Office Building, Senator Harrison A. Williams, chairman of the subcommittee, presiding.

Present: Senators Williams, Biden, and Bennett.

Senator WILLIAMS. This hearing will come to order.

We begin hearings today on S. 3126 which would grant the SEC authority under carefully defined circumstances to confine trading in listed securities to registered stock exchanges. In its simplest terms, S. 3126 is intended to insure that the mechanisms of the existing auction markets are preserved and protected until such time as we have an alternative to them, namely a national market system.

We are all aware of how rapidly conditions and behavior are changing in the securities industry. The most significant change of all will come in April 1975 when fixed commission rates are finally eliminated. The big question at that point will be the impact on the fairness and orderliness of the auction markets.

This subcommittee in its Securities Industry Study report, the SEC in various statements, and the Department of the Treasury in its recent capital markets statement, have concluded that the elimination of fixed commission rates will be beneficial. There may be a shake-out period, but most of us believe that the securities industry will emerge stronger and the public better served.

A number of responsible persons, however, do not share our optimistic expectations. The New York Stock Exchange, in particular, argues that the elimination of fixed rates will remove the primary incentive for firms to belong to stock exchanges. With that incentive gone, so the argument runs, firms will leave the exchanges, execute their orders in the third market or in their back offices, and thereby erode the strength of the auction market and the protections it provides public investors.

I do not share the New York Stock Exchange's fears, but I think we can all agree that no one can predict with absolute certainty what will happen once fixed rates are abolished. The New York Stock Exchange may be right, and that is the point of S. 3126. Focusing on the period between the end of price-fixing and the establishment of a national market system, the bill would direct the SEC, if it finds that trading away from stock exchanges—that is in the third market—is causing

serious harm to the fairness or orderliness of the auction markets, to require broker-dealers to confine their trading in listed securities to the exchanges.

There is, of course, a very important caveat to the bill's mandate. The values and protections of the auction markets, as important as they are, do not by themselves outweigh the benefits from competition. Accordingly, S. 3126 states that before the SEC can take any action to restrict third-market trading, it must ascertain that restrictive stock exchange rules have been amended so that firms now operating in the third market would be able to do business on the exchanges with no anticompetitive impact. In other words, under no circumstances would the bill put firms now operating in the third market out of business. Rather, it would require, if the NYSE's fears are realized, that third market firms be integrated into the auction markets in such a manner that they would be at no competitive disadvantage.

During the transition period until the establishment of a national market system, the SEC will be called upon to do a good deal of delicate balancing. Competition must be fostered, but at the same time, existing institutions must continue to function until there are available alternatives. The automation capacities of the securities industry must be improved, but this cannot be done at a cost which would drive a great many firms out of that industry. And trading should be centralized to assure customers best execution, but the health of regional financial centers must also be maintained. I could go on with examples, but I think the kind of regulatory balancing I have in mind is obvious.

Balancing diverse objectives is a difficult job, and I think by and large the SEC has done it well. But, in at least one area, I am afraid matters have gone askew. I have in mind the problem of equal regulation as it relates to dealer activities in the third market, on the one hand, and on the stock exchanges, on the other.

We have been told for a long time that equal regulation should be delayed in the interest of preserving and fostering the competition the third market provides to the specialists on the New York Stock Exchange. I believe in that competition, and I believe that on balance it has been beneficial to the markets and investors. But there comes a point after which we must turn our attention from the fact of competition to its fairness.

Let me give some obvious examples.

In contrast to the exchange markets, there is no public reporting of transactions in the third market, nor are all third market quotations available for public scrutiny. Third market dealers are not subject to anti-manipulative rules of anywhere near the stringency of those under which the specialists operate. Third market dealers have no obligation to honor public limit orders and indeed are not even obligated to execute their own customers' orders ahead of orders for their own accounts. Whereas specialists must trade so as to enhance the continuity and depth of markets, third market dealers have no such obligations—indeed they are not even required to trade in a manner consistent with the maintenance of an orderly market. Third market dealers can enter or leave the market at will. And short selling, which is so carefully circumscribed on the primary exchanges, is subject to no restrictions in the third market.

The competition that is provided by the third market is valuable and should be preserved. S. 3126 would do this. However, competitors should play according to similar rules. In my view, the balance between competition and investor protection with respect to the third market is out of whack. The time has come for the third market to be regulated a little more equally. I intend to discuss this point further this afternoon with Chairman Garrett of the SEC when he testifies.

We have a full 2 days of hearings on this important legislation. I hope that we will have a full and profitable exchange of views.

Our first witness today, was scheduled to be the Senator from Michigan, Mr. Hart. However, he has written me that it will be impossible for him to testify either today or tomorrow. Although Senator Hart will not testify, I will quote from his letter to evidence his interest in this matter, "Your letter inviting my comments on S. 3126 is very much appreciated. To facilitate focusing on the substantial antitrust policy questions raised, on Tuesday I introduced an amendment designed to provide competitive standards and safeguards. I trust that next week's hearings on S. 3126 will evoke comment by SEC, the Antitrust Divisions, and others on this approach. Regretfully, I will not be able to appear at the hearing on the 27th or the 28th. I will, however, be happy to file a statement on the competitive implications of S. 3126.

Again, my thanks for your thoughtfulness in inviting me and my best regards."

I am somewhat disappointed that he has created a focus on another approach. I noticed in the New York Times today an editorial which indicates Senator Hart's opposition to the bill before us here.

If my colleagues have no other statements in response?

[No response.]

We will insert copies of S. 3126 and Senator Hart's statement and amendment in the record, then, let us turn to a man who has done a remarkable job as Chairman of the Securities and Exchange Commission.

[The information follows:]

any rule of an exchange (i) fairly and reasonably prescribing priority for orders of public customers brought to the exchange, or (ii) which has been adopted in accordance with rules relating to priority of orders for public customers promulgated by the Commission under this title.

"(3) The proceeding authorized pursuant to subsection (1) may not commence until the rules of national securities exchanges fixing rates of commission have been eliminated; and any rule promulgated pursuant to subsection (1) shall not remain in effect after the Commission has determined that a national market system for securities has been established, or April 30, 1978, whichever is earlier.

"(4) Any rule promulgated pursuant to subsection (1) shall not become effective unless the Attorney General advises that such rule is the least anticompetitive means of preserving fair and orderly markets for securities.

"(5) Nothing in this title shall preempt the applicability of the antitrust laws to rules or practices of a self-regulatory body or its members which have not been specifically mandated by the Commission."

Senator WILLIAMS. Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman. I would like to acknowledge the presence of the other members of the Commission, all of whom, I am sure, you have met.

From my right to my left, are Commissioners Pollack, Loomis, Evans, and Sommer. They are here not only because they are intensely interested in the subject matter of S.3126, but also because they might be helpful in supplementing my answers to the subcommittee's questions, or in providing answers if I cannot.

For the same reason, certain members of our staff are also here—Leo A. Pickard, director, Robert C. Lewis, associate director, and Andrew M. Klein, assistant director, of our Division of Market Regulation; and Harvey L. Pitt, my executive assistant—to provide any technical information that you may desire.

STATEMENT OF RAY GARRETT, JR., CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. GARRETT. Mr. Chairman, members of the subcommittee, at this subcommittee's request, I am prepared to discuss the Commission's views on several proposals for additional legislation, each designed to make explicit the Commission's authority, after making certain findings, to require that all training in securities listed on national securities exchanges be confined to securities exchanges registered with the Commission pursuant to section 6 of the Securities Exchange Act of 1934. At present, as the subcommittee is aware, listed securities also may be, and many are, traded in the over-the-counter markets, commonly referred to as the third market.

These legislative proposals are intended to respond to, and deal with, the argument raised initially by the New York Stock Exchange—that, if the elimination of fixed commission rates, which we have proposed occur on or before May 1, 1975, takes place prior to the implementation of a central, or national, market system, the Nation's auction trading markets could be seriously impaired, to the detriment of the public interest and the interest of investors.

The Commission, at the request of various members of this subcommittee and its staff, has set forth its basic position on the question before you today, as well as our suggestions concerning certain legislative proposals in this area, in a number of letters. I am submitting copies of that correspondence for the record, but I think it might be helpful to explain briefly what our general position has been and is on this difficult issue.

After a careful review of the arguments of the New York Stock Exchange, we advised this subcommittee last December that we had serious doubts that the sequence of events predicted by the New York Stock Exchange was likely to occur. We are still of that opinion. However, we recognized then and we recognize now that it is not possible to predict the future with certainty, particularly under conditions that have never existed before. We indicated our belief, to which we still adhere, that if the serious impairment of the markets, which the New York Stock Exchange fears will result from the elimination of fixed commission rates prior to the implementation of the central market system, were to occur or appeared likely to

occur, we could seek to prevent or remove such impairment by utilizing the full extent of the authority granted to us in S. 2519, as well as any other authority we have under existing statutes.

Nevertheless, since the question has been raised of our authority to take remedial action, we have supported the efforts of the staff and the members of this subcommittee prepare specific statutory language on the subject. Inasmuch as several drafts of proposed language are before the subcommittee, I would like first to discuss the issues as they appear to us, and then relate our views on the issues to the different approaches.

The first question is whether the Commission should have the authority by administrative action to cause all transactions in listed securities to be effected on a national securities exchange in every case or in specified cases, in whole or to a limited extent. Although the decision, whenever and by whomever made, will be a difficult one—and it is therefore tempting to urge the Congress to assume the burden—we think the complexity of the matter, the variety of techniques that might be employed to produce the desired result, and the exigencies of time and timing in the face of changing and unpredictable circumstances, throw the balance, in our judgment, toward putting the burden on the Commission.

The second question is what circumstances should justify or compel the imposing of restrictions on trading in listed securities. Should it be simply actual or prospective detriment to the public interest and the interest of investors, or something more precise? Since the proposed provision is directed to a specific possible problem, and a possible remedy, it would be well for the legislation to specify the nature of the problem with which it is concerned. In this respect, however, we favor identifying the impairment that is feared as that of our securities markets generally and not simply the effect upon any particular securities exchange or market. We realize that the largest existing market in listed securities is and is likely to continue to be the New York Stock Exchange. However, we think it more appropriate for the Congress to state the subject of its concern to be our markets generally and not limit its concern to that exchange.

The third question is the weight to be given to competitive factors in fashioning the remedy, assuming that the relevant impairment or threat of impairment has been found. In this regard, we have favored stating in the statute that the remedy of restricting trading to exchanges cannot be imposed unless exchange rules at the time do not unreasonably impair the ability of nonmember firms to solicit or effect transactions for their own account. On the other hand, we think it would seriously hamper the Commission in fashioning an effective remedy for the benefit of our securities markets if the remedy had to meet the test of being the one among all possible remedies that would produce the least anticompetitive effect. Still more would this be true, if our decision under such a standard was subject to concurrence by the Attorney General.

A fourth question is one of the appropriate time at which the proceedings preliminary to a decision under this provision can or should take place. We believe that the proceedings should neither be premature nor come too late. We have a reluctance, which I am sure the members of the subcommittee share, to make such important economic

decisions on estimates and forecasts of future effects. On the other hand, we have no intention of urging that we be required to wait until if this should occur, the worst fears of the New York Stock Exchange have come to pass, before we could take effective action. It therefore seems to us, if we are to have the responsibility to resolve this question, we should also be given flexibility as to when we begin our inquiry into the problem, and when we resolve the questions presented.

Now, turning to the various proposals that are before this subcommittee, let me discuss first S. 3126 as submitted by the chairman of the subcommittee, and Senators Brock and Cranston. That bill would require the Commission to prohibit brokers and dealers from effecting transactions in listed securities otherwise than on a national securities exchange if the Commission makes specified finding with respect to the effect of exchange rules on securities dealers and on competition and with respect to impairment of the fairness and orderliness of the exchange markets or the functioning of exchanges.

We have already submitted detailed suggestions to this subcommittee and its staff for the revision of a legislative provision which is virtually identical to S. 3126. In essence, our major difficulty with S. 3126, as presently drafted, is that we do not believe the Commission should be legislatively compelled so to restrict trading in listed securities, but rather, we believe that the elimination of nonexchange trading in such securities should be one of the options available to the Commission, if we become convinced that action should be taken to avoid or correct significant injury to the securities trading process. The use of the word "shall" in S. 3126, in setting forth our authority to act, could be construed as placing an affirmative burden upon the Commission to act in the manner set forth, even though other alternatives might be more appropriate. For that reason, we believe the word "shall" should be changed to "may."

Similarly, the description in S. 3126 of the findings the Commission must make before adopting appropriate rules is troublesome. We believe that the viability of fair and orderly markets generally, not just the existence of fair and orderly exchange markets, should be the determinants upon which Commission action is predicted. In our letter to Chairman Williams, which I have referred to earlier, we set forth suggested language changes to accomplish this goal.

Another proposal before this subcommittee is one submitted by Senator Tower, originally intended as an amendment to S. 2519. Senator Tower's proposed amendment would make clear that the Commission's authority to act on this matter is granted in permissive, rather than mandatory, terms, which, of course, we favor. Senator Tower's proposal, however, would permit Commission action to deal with any impending crisis only if it could first be demonstrated that the public interest and the protection of investors were "substantially certain to be" adversely affected in the absence of such action.

We believe that this proposal may be overly restrictive. Substantial certainty with respect to future events is difficult to attain. We, therefore, prefer the "is likely to be" language in S. 3126.

The next proposal, numbered amendment 1029, is the one Senator Hart introduced on the floor of the Senate on March 19. Senator Hart's proposal has two features with which we must differ. In the first place,

it would require the Commission to hold "on the record" hearings. The effect of this as a matter of procedure and in the light of the requirements of the Administrative Procedure Act, would be to convert what is a quasi-legislative policymaking determination into a trial-type adjudication complete with cross-examination. We believe this procedure is inappropriate and unduly burdensome and productive of delay.

Secondly, under Senator Hart's proposal, no Commission action could be taken unless the Attorney General advises that it is the least anticompetitive means of preventing fair and orderly markets for securities. No standards and no time limits are provided for this determination, nor is the Attorney General called upon to, in any way, balance the interests of the public in having the best possible markets against anticompetitive considerations. Given these two features of Senator Hart's proposal, if it should become law, I seriously doubt whether the Commission would be able to act at all, or, if we could act, whether we could act in time to stave off any impending crisis. Moreover, we do not believe it is sound policy to give the Attorney General complete discretion to veto the rulemaking of an independent regulatory agency simply because he believes it should have been formulated differently. We, therefore, believe Senator Hart's proposal should be rejected.

As I stated earlier, there is an additional problem with respect to timing in all three of the proposals, S. 3126 and Senator Tower's proposal provide that no rule could become effective until rules of exchanges fixing rates of commission have been eliminated. Senator Hart's amendment would provide that the proceeding for determining whether there should be a rule could not commence until that time. We prefer the approach in S. 3126 and Senator Tower's proposal, provided that it is clear that we are not, and cannot be, compelled to resolve the matter in advance of the unfixing of commission rates.

Both S. 3126 and Senator Tower's proposal would preclude us from extending the life of any rule we did adopt beyond May 1, 1978 unless we first gave the Congress 90 days notice of our intention to extend the rule. Senator Hart's proposal would not provide for any extension beyond that date. We believe that Senator Hart's proposal would unduly hamper our ability to deal with unforeseen developments when they arise and to continue to deal with them so long as is necessary in the public interest. We would also urge consideration of elimination of the 90-day notice provision as impeding emergency action, in favor of extensions from year to year with concurrent notice of each extension.

Finally, we understand that the Treasury Department proposes to suggest a different approach which has much attraction. The Treasury proposal would provide in essence, that if we find that the fairness or orderliness of the market for listed securities has been adversely affected by transactions on an exchange and in the third market, we shall take such action as may be required to eliminate or mitigate these consequences and would specify alternatives, including the prohibition of third market trading in whole or in part. While this proposal would identify the type of problem with which we would be called upon to deal, which is the one which concerns the New York Stock Exchange, it would not mandate a specific approach, which we

might find inappropriate, but would simply require us to take appropriate action and would specify possible approaches. We believe that the Treasury approach would avoid the problems which we have discussed above, including the problem which concerns Senator Hart, of calling for action which could be unnecessarily anticompetitive. We, accordingly, support the Treasury's approach, subject, of course, to its being embodied in statutory language.

That, Senator Williams, concludes my prepared statement. We are here to answer any questions you may have.

Senator WILLIAMS. Thank you very much, Chairman Garrett.

First, I would like to deal with the situation as it is with respect to the rules regulating third market activities, but before I do that, let me make certain that I understand the last paragraph of your statement. Correct me if I'm wrong, but am I right in understanding that you are suggesting, as one of your options, the elimination of the third market?

Mr. GARRETT. Yes, as a possible, statutorily-authorized but not mandated, alternative.

Senator WILLIAMS. Where is the New York Times editorial? I specifically want to make reference to it because it contains some language that does not apply at all to the Commission as I know it today. The article reads as follows:

> Though the present Chairman of the SEC, Ray Garrett, Jr., has taken a bold stand in promoting anti-competitive reform, this was not always true of his predecessors and it may not survive his tenure.

Have you seen the editorial in today's Times?

Mr. GARRETT. Yes, I did. I thought it was an unfortunate and inappropriate attack on my predecessors.

Senator WILLIAMS. Well, prior to that, it comments on Senator Hart's position as an opponent—I'll read the paragraph for the record.

> The measure's opponents, including Senator Philip Hart of Michigan, argue that this seemingly innocuous provision has the potential of becoming a Trojan horse—one that could allow the major stock exchanges to halt the ongoing reform process. It could open the way to years of litigation and filibuster before a pliable Securities and Exchange Commission, while the established exchanges reassert monopoly control over how securities are traded and by whom.

There is a gratuity in here too. They are hypothesizing the possibility of pliable Commission. But, reference to the elimination of the third market in your statement did rather startle me.

Mr. GARRETT. I do not know whether it is semantics, Senator. The idea—that the Commission be empowered to restrict trading in exchange-listed securities to national securities exchanges -originated, in legislative terms, from this subcommittee, and has been in each of the comments we have submitted to you since, at the least, last December. We, on the other hand are not advocates of the need for such legislation. We think S. 2519 and existing law would permit us to treat the problems to which S. 3126 is directed.

Senator WILLIAMS. Let's deal with the third market for a moment, particularly the inequalities of the rules. For instance, there are no rules, at least that I am aware of, regulating the activities of dealers in the third market with respect to the many areas in which there are clear and demanding regulations on the exchanges.

First, the obligation to maintain a fair and orderly market. Why

Mr. GARRETT. Because the so-called third market does not give or award any monopoly franchises, as are received by exchange specialists, and thus there is no present need for such a rule.

Senator WILLIAMS. Are there rules applicable to the third market regarding market manipulations?

Mr. GARRETT. That is the law. It does not require a separate rule. The third market and all markets are already bound by such restrictions. It is true that the stock exchanges have specific rules for this, but it is equally true a specific rule is unnecessary. In any event, uniform rules governing market manufacturers are under preparatory, to coincide with the implementation of a consolidated tape.

Senator WILLIAMS. The protection of public orders?

Mr. GARRETT. Third market dealers do not receive public limit orders. It is the law, of course, that, if they do, they cannot trade against them. There are judicial decisions to that effect. But, Third Market dealers do not receive public limit orders. They receive market orders from other brokers.

Senator WILLIAMS. But there is nothing prohibiting them from receiving public orders.

Mr. GARRETT. No.

Senator WILLIAMS. They certainly have a great deal of business from institutions, banks— -

Mr. GARRETT. They do have business from institutions. I am not aware that it is a significant amount where compared to volume on the New York Stock Exchange.

Senator WILLIAMS. And from insurance companies.

Mr. GARRETT. And other brokers and public investors.

Senator WILLIAMS. We also consider that to be a significant part of public business.

Mr. GARRETT. And other brokers, who may well act, and often are acting for other individuals.

Senator WILLIAMS. Is there anything in the way of rules or regulations requiring the disclosure of transactions?

Mr. GARRETT. Yes and no. There is no requirement for the real time disclosure—the disclosure of transactions as they occur—because there is no vehicle to accomplish it. They are required, if they participate in NASDAQ—the National Association Security Dealers Automatic Quotation service—to make periodic daily reports of the volume of their transactions. But, they do not report transactions as they occur in the fashion that does occur with respect to transactions on the New York Stock Exchange. They will do so, of course, with respect to certain exchange-listed securities, when the consolidated tape comes into operation. That is one of the purposes of the consolidated tape.

Senator WILLIAMS. Another area in which I sense inequality is short selling. Are there any rules or regulations directed to the third market on short selling?

Mr. GARRETT. No, there is no present short-selling rule comparable to that applicable to exchange, but we have proposed one. This is in connection, again, with the forthcoming consolidated tape. We have published for comment a proposed short-sale rule that would govern third-market participants as well as exchange markets. I might add, of course, that third-market participants are subject to the same rules as everybody else if they should put their trade on an exchange.

Senator WILLIAMS. Do you see the need for equal regulations in the third market as the marketplace evolves?

Mr. GARRETT. Yes, but only as it is evolving. As Commissioner Loomis likes to observe, "Equal regulation of the unequal is inherently unequal." The central market system that we have in mind would bring competition onto an equal basis. And with it will surely come relevant and appropriate equal regulation. This is very much a part of the course we have outlined, and in which this subcommittee has concurred.

Senator WILLIAMS. Will that be contemporaneous with the central market system?

Mr. GARRETT. Well, the various facets of the central market system are not all going to come into being at one time. The first major step toward it, putting aside the unfixing of Commission rates, will be the implementation of the consolidated tape—the tape reflecting historical securities transactions, as you know.

All the participants and the Commission have agreed that, when the composite tape goes into effect, there should be equal regulations governing manipulative conduct, short sales, and rules that you have not mentioned yet, trading talks. You have not mentioned talks, presumably because the context where such rules might be necessary does not yet exist under present circumstances.

These are the regulatory factors that we have agreed should be equalized before the tape becomes operational and we will have adopted then by the time this tape is physically ready to begin.

Senator WILLIAMS. But the first fixed point of significant change will be April of next year when the Commission has announced clearly and irreversibly that the fixed commissions across the board will be eliminated.

Mr. GARRETT. That is scheduled for the end of April. May 1, 1975, will be the first fully unfixed day, by which time, of course, we expect to have the consolidated tape in full operation.

Senator WILLIAMS. Do you expect that the rules and regulations you are now in the process of developing dealing with the third market will be in effect, in whole or in part, by that date?

Mr. GARRETT. I expect that rules on the three subjects I have mentioned will be in effect on that date. These are the only rules we believe are relevant to the consolidated tape. Now, the other rules with respect to operating in the full central market system under the program, as we envision it, are keyed in to the adoption of a composite quotation system, and certain other rulemaking developments that must occur. I cannot say with certainty that that is going to occur by May 1, 1975. I think the New York Stock Exchange would agree that, if we were all certain they would occur by May 1, 1975, we wouldn't be here today. They have stated that, if all the components of the central market system were in existence on that day, they would not have this problem and would not be seeking this kind of relief. But, we do expect it to be in place as soon thereafter as possible. And, of course, ideally, it would be in operation and in being so at that time this problem would never actually arise. I can't promise that that is going to be the case.

Senator WILLIAMS. It is that lack of certainty that brings us to the consideration of this bill. It appears that the time gap between the

elimination of fixed commission rates and the installation of the national market system may operate, according to the NYSE, to furnish incentives to firms to relinquish their exchange memberships. Part of the incentive, I would imagine, would be the lack of equal regulations in the third market.

Mr. GARRETT. Well—you mean weighed against the protection of the fixed commission?

Senator WILLIAMS. Exactly.

Mr. GARRETT. Possibly. Many have asserted they could make more money off the exchange. But, if they really thought they could do so, they would be there now.

Senator WILLIAMS. Well, these firms obviously want to protect their businesses, and I am certain that they are now in the process of evaluating a number of factors bearing upon the business judgment whether to operate on an exchange or elsewhere. One factor under consideration would be the New York Stock Exchange's recently announced reduction in rates for some orders——

Mr. GARRETT. No; that was a member firm of the New York Stock Exchange, and it will not start until next week. It will start on Monday.

The question of equal regulation does not affect many members directly. We are talking about the regulation of specialists as opposed to the regulation of third market markets. Members of the exchange have the obligation to put their transactions on the exchange; that is true. For this, they now get the benefit of charging a fixed commission.

Senator WILLIAMS. That's the point, Mr. Chairman. When there are no longer fixed rates, and there are no regulations in the areas we have been discussing, you can theorize that part of the incentive to leave the exchange would be to escape the exchange pattern of regulation and become a freewheeler in a relatively unregulated market.

Mr. GARRETT. I don't see that at all, Senator.

Senator WILLIAMS. Well, I may not either, but this is a theory that has been advanced by responsible spokesmen and I believe it warrants our attention.

Mr. GARRETT. That's not the way they explained it to me.

Senator WILLIAMS. They may not use the word "freewheeler" but I think the message that is communicated is clear enough. It is that less regulation means more opportunity.

Mr. GARRETT. They do not even talk about the lack of regulations; they talk about the money they are going to make off the exchange. It is not because of lack of regulation that they threaten to leave the exchange; it is because of the spread they think they can charge for making dealer markets and tracking from their own inventory.

Senator WILLIAMS. We have already been over this briefly. But perhaps we can take some specific examples where there is a conspicuous absence of third market regulation—short selling is a standout. Shortselling on down ticks is possible in the third market, is it not?

Mr. GARRETT. They will not be able to do so.

Senator WILLIAMS. We're talking about making money, aren't we?

Mr. GARRETT. It is a good way to lose money.

Senator WILLIAMS. Well, I've never been asked to sell short but, there are some successful short sellers. Nevertheless, the advantage is that there is no rule or regulation applicable to short selling in the third market.

Mr. GARRETT. By May 1, 1975, we will have a short sale rule in effect that will apply to the third market.

Senator WILLIAMS. Another example occurs in the context of the phrase that has guided our markets for so long—fair and orderly markets. Will there be a rule in effect by that date also governing the market making conduct of those in the third market?

Mr. GARRETT. Not in the sense you presumably mean, although over-the-counter markets must be fair and participants in those markets are regulated. Unless, of course, at that time we are significantly further along toward the central market system. And of that I am not certain.

Senator WILLIAMS. You can see the arguments that are advanced that would suggest the need for SEC residual authority to deal with any situation arising between the unfixing of commission rates and that day when the national market system is plainly visible and operational.

Mr. GARRETT. Certainly. And S. 2519 would give it to us. Your suggestion is that an alternative, limiting trading in listed securities to the New York Stock Exchange, as opposed to the third market that does not now exist. That is one of the flexibilities that we want to be able to apply, if it should be necessary to do so.

But, that is one reason why we do not favor a bill that offered only a single remedy to the potential disintegration of the auction market.

Senator WILLIAMS. I am aware of the correspondence that you mention and the language changes that you suggest in this bill. Are these other alternatives suggested as amendments?

Mr. GARRETT. No. We don't need them as amendments, since we already have that authority in S. 2519 and existing law. But their absence should not imply that we do not desire to be relieved of any compulsion to apply only one remedy—namely, restricting all of the transactions of the New York Stock Exchange—as the only way in which we can prevent people from removing their trades from the exchange.

Senator WILLIAMS. This is not legislation that deals with one exchange. Rather, the intent is clear enough on the face of the bill that there is to be general applicability to exchanges.

Mr. GARRETT. Which has led us to comment, in our earlier letter, that the relief sought might not work anyway. If all third market makers went to the Cincinnati Exchange, for example, it might make a limited difference to the New York Stock Exchange. But it is true that this bill would apply to all exchanges. And the requirement set forth could be met by putting the trade on any exchange on which the security is qualified to be traded, and not necessarily on the New York Stock Exchange.

Senator WILLIAMS. Could we be kept advised of the status of developments in the regulations I have discussed with you today concerning the third market? I think it would be helpful for our consideration of this detail if, within 30 days, the Commission prepared a status report on its efforts to develop an equitable regulatory framework.

[A letter was received from the SEC at a later date. It may be found at p. 171.]

Mr. GARRETT. All right. As you know, Senator we are in the process of appointing an advisory committee, to be chaired by Mr. Alexander Yearly IV, chairman of the Robinson-Humphrey firm in Atlanta, whose task will be to advise us on moving from where we are now to the full central market system. And we are anxious for you to get acquainted with him. We are developing a program with him that will involve equal regulations as well as a number of other matters. We will certainly report to you within 30 days, and as often thereafter as we have any news.

Senator WILLIAMS. I appreciate that.

Just to recap some of your specific suggestions for this legislation; you recommend that "shall" should be changed to "may"?

Mr. GARRETT. Yes.

Senator WILLIAMS. That would give you greater flexibility.

You say that "exchange" markets, should be deleted and replaced to describe markets in general. Frankly, I am not sure I understand that.

Mr. GARRETT. The markets in general, as we develop the central market system, and particularly as other regulatory and mechanical devices come into play, should be the dominant factor, and not just what occurs on the stock exchanges. Right now they sound like the same thing but I don't know what they'll sound like a year from now.

Senator WILLIAMS. Thank you. Senator Biden?

Senator BIDEN. Thank you, Mr. Chairman.

Mr. Chairman, I want to make sure I understand what you are saying.

The thesis of what you're saying is that you don't anticipate any rush from the floor to the third market to begin with. However, if that unanticipated event were to occur, you want the flexibility to deal with the situation; is that correct?

Mr. GARRETT. Yes.

Senator BIDEN. If you don't anticipate with any degree of likelihood that there will be a substantial decline in exchange membership, then isn't it a bit too soon for Congress to write a so-called fail-safe provision in the bill?

Mr. GARRETT. Well, our initial thought was that it did not need separate and express acknowledgement. We believe that the powers otherwise granted to us by the Securities Exchange Act, as it now stands, and the amendments to those powers that will be provided by S. 2519, will give us sufficient authority to take various steps to cope with the problem.

However, the problem was brought into public debate by the request of the New York Stock Exchange, initially, when it suggested that trading in listed securities be limited to registered securities exchanges by statute. We did not think that was a good idea because we did not think the probability of their fears coming to pass was sufficiently great. Not because we believed that their fears could not create a problem, but because we think that they should not. The discussions then led to something that did not seem to be intelligent, that is to say, that the act was going to talk about this problem in a restrictive manner. It would be better to talk about it in terms of giving the administrative agency the authority to fashion appropriate relief

and take appropriate measures if the fears we have heard so much about should actually come to pass.

Senator BIDEN. What are those conditions which would evidence the fact that the fear has come to pass?

Mr. GARRETT. I think a wholesale defection of traders away from the New York Stock Exchange could be a very alarming development.

Senator BIDEN. What does that really mean? Does that mean that the membership would drop off 20 or 25 percent, or 50 percent, or 80 percent?

Mr. GARRETT. I do not mean to be facetious, Senator. If I had a clear idea as to exactly where the line lay, I would suggest that you put it in the statutes. But, I do not. Other variables exist at the same time. I suppose, from an economic point of view, I would have to say, that a state or point could be reached that would affect the markets to a significant degree, if trading and liquidity in a significant number of stocks on the floor became so thin that we ceased to have an auction market in those stocks at a time when we had not yet gone far enough toward developing the equivalent of an auction market in the central market system.

I must say, we are also concerned with the financial well-being of the New York and other stock exchanges. We need them as part of our overall regulatory program. We could not get along without them for a lot of reasons, although there are many other ways to help finance exchanges.

Senator BIDEN. I'm not really trying to nail you down, but I'm trying to point out for the record that it is a difficult line to draw where these fail-safe provisions would take effect and I'm concerned that perhaps the bill should be drafted to try to describe more clearly what that situation would be.

Mr. GARRETT. That is what leads us to prefer a proposal that we did not think of ourselves—the Treasury Department's proposal—which, I am sure, Mr. Schmults will more thoroughly explain. The virtue of that proposal is that it starts out by defining the problem. It does not start out, as S. 3126 does, by defining the remedy. Of course, we have not seen any specific language. Then the Treasury proposal provides that, if these fears are coming to pass, or are very likely or substantially certain to pass, the Commission shall take certain steps to remedy the situation, choosing from various alternatives.

Senator BIDEN. I'd like to see a little more about that, too.

Senator WILLIAMS. Thank you. Senator Bennett has to leave, so if we could interrupt for a moment, it would be appreciated.

Senator BIDEN. Surely.

Senator BENNETT. I'm just interested on the bottom of page 2 you indicate on the bottom line that you have other authorities under existing statues under which you can act. Do you mind identifying some of those for the record?

Mr. GARRETT. We have authority under section 19(b) of the Securities Exchange Act, in effect, to compel the adoption of rules by registered securities exchanges in a rather broad list of areas. While our authority over members and nonmembers of exchanges is pervasive, it is not comparable in all respect to the authority we have with respect to exchange members. In some cases, it is broader; in others, it is cast in different terms. One thing that S. 2519 would do that

does not now exist would be to expand and make comparable all of our exchange and nonexchange member authority that would be helpful. However, there are other ways in which some aspects of this problem could be approached. For example, rules treating this issue could be adopted under the general fraud provisions of our statutes.

Senator BENNETT. That might be going around Robin Hood's barn instead of directly to the heart of the problem.

Mr. GARRETT. It would be helpful to have our authority made explicit, as S. 2519 would do.

Senator BENNETT. What rule changes do you anticipate in the New York Stock Exchange or that they would have to make to meet the requirements of section (c.) (1a) of S. 3126?

Mr. GARRETT. Let me be sure that I have the right section. One rule, in particular. If third market firms were to be given competitive specialist positions on the New York Stock Exchange, Rule 113 of the New York Stock Exchange presently would forbid their doing business directly with institutional investors which, of course, is their principal business.

Senator BENNETT. That rule would have to be changed?

Mr. GARRETT. In some respects; otherwise, to bring the third market firms on to the exchange would drive them out of their separate markermaking businesses. I understand it is not the intent of S. 3216 that that should be required.

Senator BENNETT. Mr. Chairman, I'm sorry, I'm very sorry, but I have to go. Thank you for yielding to me, Senator.

Senator BIDEN. If I may follow up with my line of questioning. We agreed that it's difficult to determine what would constitute the demise of the exchange, but I have found broad disagreement on this point.

Mr. GARRETT. It sounds familiar.

Senator BIDEN. Because of the great uncertainty as the effects of this legislation, I have been told that I will destroy the exchanges without it, but that I must really be in the pocket of the exchange in order to support it. I think it is legitimate criticism by those in the third market who say that if you leave this provision wide open, you've avoiding your congressional responsibility. You're writing an act and if you're going to be one of the legislators, you cannot do that. I don't believe it is proper for Congress to, as it so often does, delegate all the authority to anyone it can find to take it. Now that's a very open ended question, but I would like you to try and respond, if possible.

Mr. GARRETT. It runs to the very heart of the matter. Without trying to psychoanalyze what any of the various participants in this matter really want, however, and taking their arguments at face value, there certainly appears to be some substance to the arguments. I suppose the New York Stock Exchange, for one, might say: "This danger is real, and if you wait until you can see it, it will be too late. You have got to prevent it from occurring to begin with. The only way to prevent it is to prevent it now, and Congress ought to take the responsibility." I know third market makers would say exactly the opposite thing: "There is nothing to the Exchange's argument and to create this temptation is to ensure that we will end up dead on the floor in the process."

It is our opinion at the Commission that, notwithstanding the criticism of some, that there has been too much delegation of power

to administrative agencies; this is one area which should be delegated to the agency that has been given responsibility of regulating our markets and taking appropriate action. It is a very complex subject, to be sure. Anyone that sits here today and thinks he can say exactly what the market will look like, structurally, to say nothing of price and volume, a year and a half from now, is kidding himself. We do not know and they do not know. We guess and they guess. We think our guess is better than theirs and vice versa. There are too many other things moving at the same time that are likely to change circumstances: regulatory matters and procedures, electronic capabilities, market habits and many other variables.

I think the decision on these issues should be left with the responsible body whose full-time job it is to keep up with and try to understand these matters, with guidance from the Congress, of course, as to the parameters within which we should act.

I think the bill tries to do that. Both versions do. We should preserve as much competition as possible and still bring forth a decent auction market law with standards that we can understand.

Senator BIDEN. Thank you, Chairman Garrett, for your response to my vague and general questions. What I'd like to do now is be a little more specific. Now, you say you want more flexibility?

Mr. GARRETT. Yes.

You say you want the flexibility to go beyond the requirement that all trading in listed securities be confined to exchanges.

Mr. GARRETT. Short of requiring all trading in listed securities to occur on an exchange, not beyond.

Senator BIDEN. Thank you. Can you give me some specific examples of alternative action the Commission might take if the Congress were to provide more flexible rule-making authority in this area?

Mr. GARRETT. Do you mean the types of things short of restricting all transactions in listed securities to registered exchanges?

Senator BIDEN. Right. If you could list some for me.

Mr. GARRETT. One possibility that has been suggested, and publicly discussed, would be for us to require that third market firms check the market on the New York or other stock exchanges before executing orders for other customers.

Senator BIDEN. When you say "check," what specifically do you mean?

Mr. GARRETT. Find out quotations from exchange specialists and whether such quotations are better than those offered elsewhere and dispose of these orders in a way which would clear the specialist's book. This is one possibility. Another is to say that if anybody is making a third market in a listed security, as Professor Ratner has suggested, they should not deal with the public but only with dealers on a wholesale basis. This would discourage the major retail firms from leaving the exchange in order to integrate forward into making markets in listed securities. That is a possibility. Exposure of public orders over the NASDAQ system, for example, is another possibility. That would make possible an auction. It certainly would expose such orders to a wide audience of possible takers. Things of this kind, and ideas that we have not yet thought of, might help the situation.

That is the sort of thing about which we have thought.

Senator BIDEN. What would be the position of fourth market firms if the provisions of S. 3126 were to take effect? Would they be put out of business?

Mr. GARRETT. I think at the moment the real fourth market would be left untouched. S. 2519 would give us authority to reach them, I believe. Mr. Robert Lewis, Associate Director of our Division of Market Regulation, can add to this discussion.

Mr. LEWIS. To the extent that trades occur between individuals who are not registered with the Commission as brokers or dealers, S. 3126 would not reach them. The Commission would have no authority, under S. 3126, to require such transactions to be effected on an exchange.

There is, however, a grey area with regard to some participants in the fourth market because there is some confusion of terms. Instinet, for example, is sometimes classified as a fourth market participant. Nevertheless, Instinet is a broker-dealer registered with the Commission, so that its trades would have to be taken to an exchange under S. 3126, absent some exemption. That fact may very well put Instinet, or any similar electronic system, out of business. Brokers that handle crosses between institutional clients are sometimes classified as being in the fourth market, but they are broker-dealers registered with the Commission.

To require that transactions by broker-dealers in listed securities be taken to an exchange probably would also put those persons out of business, again absent some sort of exemption.

Senator BIDEN. Should S. 3126 be enacted, what burden do you think would be placed on the third market firms? Would there be any?

Mr. GARRETT. Well, there would be no burden until we acted pursuant to the authority granted. The burden, until we did act, would be the uncertainty as to what we might do. When we did act, it would depend on our actions.

Senator BIDEN. It would depend on your actions?

Mr. GARRETT. Yes; it would depend on our actions. I do not mean to be facetious, but, even if we took full advantage of the authority granted to us to require all transactions to go on an exchange, the exact details of the requirement would define the extent of the burden. It would depend upon what the access rules would have to be to meet the requirements of the bill. This might not prevent their doing their own business directly, but it certainly would at least require them to expose all of their business to the specialist's book to give the public an opportunity to participate in their trades.

The public does not have an opportunity to participate in third market trades now—as the exchanges would be quick to tell you.

Senator BIDEN. In discussing S. 3126, we have been told that one of the purposes of it is to avoid "chaos" in the auction markets. What do you envision as "chaos?"

Mr. GARRETT. I have not heard the term "chaos." I have heard the term "drying up" or "disappearance of" the auction market and the takeover of the auction market, by dealers conducting business "upstairs," as the street calls it, rather than down on the floor. This need not be chaotic at all. In fact, the over-the-counter, or "third," market could be quite orderly. It does not, however, have the virtues attributed to an auction market and we take these virtues seriously. Among these virtues are the possibility of protecting public orders, permitting them to participate in trades, and to some degree, the price or value setting mechanism of the auction market, which seems to be more believable or to have more credibility when it takes place down in an auction crowd rather than elsewhere. But, that does not mean the third market is chaotic; rather, simply that it is one kind of market rather than another.

Senator BIDEN. I guess by the choice of the term chaos, you don't have to guess who I've been talking to.

Mr. GARRETT. No.

Senator BIDEN. S. 3126 would require that anticompetitive rules of the exchange be eliminated before the directives can be carried out. Would you please comment on the necessity of eliminating the following rules of the New York Stock Exchange: First, rule 113 which prohibits specialists from dealing directly with certain kinds of customers.

Mr. GARRETT. If third-market makers, as a result of requiring their trades to be effected on an exchange, were to be given positions as specialists, alternate specialists, or something of that sort upon the exchange, rule 113 would forbid them from dealing directly with institutions as well as corporate insiders; that would drastically change the business of third-market firms in a manner inconsistent with the standards set forth in the proposed bill.

Senator BIDEN. Rule 438 which prohibits market makers other than specialists from quoting two-sided markets in a security.

Mr. GARRETT. It is a little hard to know exactly how it would work. If the power under the bill were used simply to require third-market firms to become members of the stock exchange, and they had to send all of their transactions to the floor, then, of course, they would have to stop their activities off the floor, which would stop two-sided quotations in the third market altogether. Rule 438 would have to be modified to permit them to do it.

However, I don't think rule 438, in its present form would be considered consistent with the anticompetitive standards set forth in the bill.

I must say again, in case it is not clear, that these are representative of the kinds of decisions that the Commission would have to make in an appropriate way if the bill's authority ever were to be used. I do not mean to be understood as foretelling what the decision might be.

Senator BIDEN. The intent of this question is not to put the exchange or the Commission in a corner to promise future actions. But I am trying to analyze these provisions to make it clear for the record.

I think it's worthwhile to give a broader picture of the possibility of what might occur.

One further part of this last question, Mr. Chairman. We are talking about the requirements of S. 3126 that anti-competitive rules be eliminated. Would there [also] be a [need to] eliminate membership on the exchange on a medallion basis.

Mr. GARRETT. Yes; restricted membership would have to be eliminated. Whether it would have to be eliminated for everybody or whether alternative concessions could be made to third market firms is something different to predict, but one can hardly imagine that the only solution or remedy under S. 3126 is that third market firms

would be required to obtain full membership on an exchange as the concept of membership is now understood.

Senator BIDEN. Thank you very much, Mr. Chairman, and thank you, Mr. Garrett.

Senator WILLIAMS. Let me return to the statement you made a moment ago, Mr. Chairman, limiting ourselves to the New York Stock Exchange. I believe this is very important to the bill. You favor identifying the markets generally. We are not singling out any particular exchange market. We realize that the largest existing market in listed securities is likely to be the New York Stock Exchange. However, you think it is more appropriate for the Congress to state the subject of its concerns, to be our markets generally, and not to limit its concern to that particular exchange.

We discussed earlier a lot of the anxiety expressed by that exchange. The language of the legislation, however, is to exchange, is it not?

Mr. GARRETT. Correct.

Senator WILLIAMS. I do not fully understand the market "generally" that you refer to. Perhaps there is an unknown market?

Mr. GARRETT. Or some changes in the third market not now present.

Senator WILLIAMS. It is my understanding this can be clarified within our bill to make clear that it is the auction markets that we are interested in preserving and protecting. In fact, the exchanges too would have us address ourself to this point.

On page 2, line 10, it has been suggested to change that line to read "the fairness or orderliness of the auction market for such securities."

Mr. GARRETT. We didn't say auction markets in our version; I don't know where that came from.

Senator WILLIAMS. My understanding was that this was your suggestion. Perhaps, I misunderstood my information, but I thought this was the result of a staff level discussion.

Mr. GARRETT. Our proposal should have read: "Fairness or orderliness of the markets for such securities." We would simply delete the phrase "such exchanges."

Senator WILLIAMS. Yes, the word auction is included in there. "Auction markets for such securities * * * or the ability of the exchanges to carry out their regulatory responsibilities * * *."

Mr. GARRETT. That was not one that we had recommended, sir.

Senator WILLIAMS. How does it strike you? This was not unilateral from here, as I understand it. It's been a staff matter, and it's bilateral, yours and ours.

Mr. GARRETT. Yes, we discussed it, but we did not include it in the recommended versions. You ask me what we think about it now?

Senator WILLIAMS. Yes.

Mr. GARRETT. I would prefer, again, that the relevant universe of concern be the total state of our market.

Senator WILLIAMS. To make clear that we are talking about the role of auction markets.

Mr. GARRETT. Well, like everything else, it also relates to the whole business. What we do not want is a situation in which, because there is some decline of trading on the New York Stock Exchange and some increase in third market trading, we are compelled to restrict all trading to stock exchanges.

Senator WILLIAMS. I don't believe that version

Mr. GARRETT. Do you want to look at the overall health of the markets, or just of the auction markets, to use that term?

Commissioner LOOMIS. I think the problem with the use of the term "auction market" is that neither the New York Stock Exchange nor the over-the-counter market is a 100-percent auction market today. Definition of an "auction" market or a "dealer" market is difficult, while the term "market" encompasses both.

It was our desire to encompass and preserve both kinds of markets.

Senator WILLIAMS. Now, your broader phrase, then, would be to use the phrase "markets" rather than with any specificity or description?

Mr. GARRETT. That is our recommendation. Yes, sir.

Senator WILLIAMS. That is all I have.

Mr. GARRETT. May I ask if any of the other Commissioners would like to supplement anything that I have said?

Senator BIDEN. Mr. Chairman, may I ask one final question? I believe that the third market now provides a competitive force to stock exchange specialists by the competing markets it provides for certain listed securities.

Wouldn't that competitive force by definition be eliminated by a requirement that all trading in listed securities be confined to exchanges?

Mr. GARRETT. Yes, we would restrict or eliminate the third-market maker's ability to compete with the specialist in market making to the extent that the third market maker had to take his order to a specialist, like anybody else, and subject himself to the specialist's book, if not to the specialist's own bids.

The degree to which this would happen, I think, would depend upon just how it was worked out, the worst thing, from the third-market maker's point of view, would be to require him to become a member of an exchange under present exchange rules and requirements. Nobody contemplates that because it would be inconsistent with the standards already set forth in S. 3126. The least disruptive action, I suppose, might be to require their orders at least to be exposed to the specialist's book. It could be anticompetitive, I'm sure.

Senator BIDEN. Is it fair to say that such a move could be made and still have a competitive situation?

Mr. GARRETT. I think so. I do think it is possible. I would like to make it very clear, particularly because of one of your opening questions, Mr. Chairman, that it is not our intention or desire or target to act under this bill. Our target is the central market system within which the third market will compete in a thoroughly integrated, fair, equally regulated system. The last thing we want to do is exercise the full authority proposed under something like S. 3126. But, as a matter of honesty, I have to say this is one of the alternatives that ought to be available to us.

On the other hand, we do not think it ought to be the only alternative available, which is what we are afraid S. 3126 does.

Senator WILLIAMS. S. 3126 does not repeal any other authority delegated to the SEC?

Mr. GARRETT. But by using the word "shall," S. 3126 provides the basis for an argument that, if we find a decline in the auction markets, and if the other conditions in the bill are met, we must restrict all trading in listed securities to exchanges. We are further worried about

the record will very clearly show that this decision need not be made before commissions become unfixed, if S. 3126 becomes the law, as I stated in my testimony.

Senator WILLIAMS. That's clear but on the other question of whether this displaces all the authority that you have suggested you have, we do not disturb that. But you believe that the mandate of "shall" is the thing that could cause some displacement. Is that right?

Mr. GARRETT. The use of the word "shall" does not displace our other authority. But, if we make the findings S. 3126 contemplates, then I think someone could argue to a court that we have to grant this relief, if relief is the right word to call it; we do not want to have to do it. We want to be able to make these findings and use other measures short of this if they will do the job for that reason, we believe the statute should use the word "may," to avoid any ambiguity and to preclude this argument from even being made.

Senator WILLIAMS. Under the bill, the Commission would make the findings that serve as the basis for the provisions of this bill going into operation. In other words, the Commission must make certain findings?

Mr. GARRETT. Yes.

Senator WILLIAMS. Do you have any partnership in that? Would you have a court sharing your responsibilities?

Mr. GARRETT. Well, first of all I think we would have to be honest in making the findings and we could not refuse to make them just because we did not like the relief that such findings would bring about.

Second, of course, our action presumably would be subject to some judicial review, to a degree, with the word "shall."

With the word "may," we could not be compelled to take any action.

Senator WILLIAMS. In an effort to correct any emerging adverse situation in its incipient state, you could use other power and authority conferred by law, before invoking the remedy prescribed by this bill. Am I correct?

Mr. GARRETT. I do not want the bill to provide a basis for anybody to say that we are compelled to hold hearings and to resolve this matter before commission rates become unfixed, because I know the consequences of that. It will drag on and the next argument will be that we must postpone the unfixing of commissions, and that is the kind of delay a court might require of us under S. 3126.

Senator WILLIAMS. Well, we didn't say anything about putting this into operation before commission rates are unfixed.

Mr. GARRETT. You don't say it, but I think, sir, that you are providing a foundation for this kind of trouble.

Senator WILLIAMS. I don't think there is any authority in the Commission in this bill to act before commission rates are unfixed.

Mr. GARRETT. It says we should restrict trading to exchanges if there is likely to be any significant harm to the auction markets.

Senator WILLIAMS. As I understand this bill, it is directed to the period of time after commission rates are competitively determined.

Mr. GARRETT. It only hinges on a finding that there is likely to be harm after commissions are unfixed.

Senator WILLIAMS. I am glad we had this discussion.

Mr. GARRETT. If you made it clear that this is not the intent, that at least would help.

Senator WILLIAMS. Well, that is why this is the best of legislative practices. Thank you, Mr. Chairman.

Mr. GARRETT. Thank you very much.

Senator WILLIAMS. Our next witness is the General Counsel of the Department of Treasury. We will come to order because we have a vote almost upon us.

STATEMENT OF EDWARD C. SCHMULTS, GENERAL COUNSEL, DEPARTMENT OF THE TREASURY, ACCOMPANIED BY DAVID STOUGHTON, STAFF MEMBER

Mr. SCHMULTS. Mr. Chairman, members of this subcommittee, my name is Edward C. Schmults. I am the General Counsel of the Treasury Department. The Department is very pleased to have this opportunity to present its views to you today.

Present with me is David Stoughton, who is a member of the Treasury staff. He's sitting on my right.

As you know, the Treasury has taken an active interest in the various legislative proposals for reforming the structure and regulatory system of our securities markets. We feel that the prospects of achieving the common goal of a vigorous and healthy national market system, operating in the public interest, can only be enhanced by a broadly based consideration of the troublesome questions involved.

It was with this view that the Treasury commissioned Prof. James H. Lorie to prepare the recently distributed statement entitled "Public policy for American capital markets." Secretary Shultz, Deputy Secretary Simon and others at the Treasury and other Federal agencies devoted considerable time to the series of discussions leading to that statement. Secretary Shultz wanted to be here today but he had to be enroute to the Inter-American Development Bank annual meeting in Chile. The testimony I am giving today reflects the views of the Treasury Department.

We hope to work constructively with the Congress, the Securities and Exchange Commission, the financial community and others in the development of securities legislation which so vitally affects the economic fiber of the Nation. Accordingly, I welcome this opportunity to address the subject of the role of the third market in a national market system, and more specifically the question whether the Securities and Exchange Commission should be given a specific grant of power to prohibit third market trading, in whole or in part, in the event adverse consequences appear as we move under a competitive rate structure toward the creation of a national market system.

The bill now before the committee, S. 3126, provides, in effect, that the SEC must prohibit third market trading, in whole or in part, if it finds after notice and opportunity for hearing that, as a result of third market transactions the fairness or orderliness of exchange markets or the ability of exchanges to carry out their responsibilities under the Securities Exchange Act of 1934, has been or is likely to be affected in a manner contrary to the public interest and the protection of investors.

Before addressing the merits of S. 3126, let me briefly explain Treasury's views concerning the role of the third market in the national market system. We agree with the SEC that a key objective of

Mr. SHERRILL. I cannot give you the exact figures. I would say that an overwhelming majority of the members of the SLA support that policy.

Senator BIDEN. Some of the larger members, like Goldman-Sachs do not support that position, do they?

Mr. SHERRILL. Goldman-Sachs is one member. We have 745. I was not aware that Goldman-Sachs did not support that policy.

Senator BIDEN. That is the question I am asking you.

Mr. BRADFORD. I think they do, do they not?

Mr. SHERRILL. I think they do, but I cannot speak for them.

Mr. SCRIBNER. I do not know about any specific firm. Our portfolio does not consist of representing any particular firm or group of firms, but to voice industry positions that have been developed over time and after study by men such as these with me at the table. I think the position with regard to the trading of all listed securities on the exchanges has a strong consensus behind it.

It has been deliberated and discussed on many occasions within our governing council and board, and I think it does represent the strong feeling of the industry.

Senator BIDEN. We were discussing earlier the question of whether or not moving to negotiated rates is going to move your members away from trading on the exchanges or to them.

In the testimony in the *Thill* case, I understand the chairman of the board of Merrill-Lynch, and Mr. Levy of Goldman-Sachs, among others, I believe, indicated it might very well have the exact opposite effect.

I would like to read from prepared testimony which has been submitted for later presentation:

> Fixed commissions are one of the causes of trade leaving the New York Stock Exchange and going to the third market. Continuing market rates will make it more difficult for member firms to exit.

This is a quote from the testimony of Mr. Levy.

> Upon further reflection since that time as a result of my experience with negotiated commissions on large industries, I have changed my views regarding the desirability of moving to the negotiated rates. It would not necessarily follow that the competitive commission rates on transactions of all sizes would have an adverse effect.
>
> Having negotiated commissions would not cause my firm to leave the New York Stock Exchange.

These men represent quite large member firms, don't they?

Mr. SHERRILL. Yes, they do.

Senator BIDEN. Is there a difference of point of view within your organization between relatively larger and smaller member firms?

Mr. SHERRILL. I do not think that that really is germane to the decision that these gentlemen have arrived at.

What we are afraid of is they might be wrong. All we are asking for is that a mechanism be set up which in the event that these seers have made a mistake, will prevent the destruction of the auction market.

Senator WILLIAMS. There is a vote in the Senate. I think we will break now and then return to the panel of Mr. James Needham and Mr. Owens.

We have an ambitious schedule ahead of us, gentlemen. We have to move rapidly when we return after this vote.

[Recess.]

Senator WILLIAMS. All right we will resume immediately.

Mr. James Needham, chairman, New York Stock Exchange, and author; Mr. Cornelius Owens, executive vice president of American Telephone & Telegraph Co. and now on the board of directors of the New York Stock Exchange; and Mr. Donald Calvin, vice president of the New York Stock Exchange.

STATEMENT OF JAMES J. NEEDHAM, CHAIRMAN, NEW YORK STOCK EXCHANGE, ACCOMPANIED BY CORNELIUS OWENS, EXECUTIVE VICE PRESIDENT, AMERICAN TELEPHONE & TELEGRAPH CO., AND BOARD OF DIRECTORS, NEW YORK STOCK EXCHANGE; AND DONALD L. CALVIN, VICE PRESIDENT, NEW YORK STOCK EXCHANGE

Mr. NEEDHAM. With your permission, Mr. Chairman, I will submit my statement for the record.

Senator WILLIAMS. Fine (see p. 98).

Mr. NEEDHAM. Mr. Owens, in addition to being one of our most distinguished directors is executive vice president of the American Telephone & Telegraph Co. He has been a member of the exchange board since 1968 and headed the special committee whose report led to the 1972 reorganization of the exchange's governing structure. Following the conclusion of my remarks, he will offer some further brief comments on the need for this legislation.

We are pleased to have the opportunity to appear at these hearings to express the support of the board of directors of the New York Stock Exchange for S. 3126.

May I say at the outset that we appreciate the concern shown by the entire committee in this matter of appropriate safeguards for public trading on the Nation's stock exchanges—and particularly by you, Mr. Chairman, by the bill's cosponsors, Senator Alan Cranston and Senator Bill Brock, and especially by the entire staff of the committee.

When the provision which is now S. 3126 was under consideration as a possible amendment to S. 2519, the exchange's board had an opportunity to review it in depth. At that time, the board took the position that while the proposal did not go as far as the board would have liked with respect to preserving the securities auction markets, it did represent a fair compromise which merited the exchange's support. Our position today is the same.

Rather than restate the concerns which we presented in great detail to this subcommittee in our appearance at hearings on S. 2519 last November, I would like to focus today on the essential public-interest aspects of this issue.

At the heart of S. 3126 is the public policy determination that it is in the vital interests of more than 30 million American investors to preserve the public exchange auction markets in this country.

There is near universal agreement on this point. You, Mr. Chairman, stressed it when you introduced the National Securities Market System Act on the floor of the Senate last October. The hearing record on that bill is filled with specific affirmations by the SEC and by representatives of the securities industry.

Mr. Chairman, the text of the various comments of the SEC and

note the chairman's comment to the Senate on March 6 when you described S. 3126 as "a major piece of securities legislation which will go a long way toward speeding the development of a central market system and bolstering investor confidence in the markets."

The SEC has underscored the fact that the element of public confidence so vital to individual participation in the securities markets is not well served by dealer markets. Consider this illuminating description of a dealer market from the Commission's March 1973 white paper:

> Presumably, the classic example of a dealer market is the over-the-counter market, in which it is virtually impossible for an investor's order to be executed without the participation of a dealer in the transaction. There is no facility whereby public orders can offset each other, except under the auspices of a market maker, and this rarely occurs. Since the intervention of a dealer involves an additional spread between the prices at which investors can buy and sell, it is likely that in many instances investors obtain less favorable prices on their trades than if they could trade with other investors.

By contrast, the advantages of a public exchange auction market may be demonstrated by describing simply how transactions are handled on a stock exchange.

In an exchange auction market, all public orders are treated fairly—with the first order received at the best price receiving priority over other orders. This is so regardless of whether that order is from an individual investor purchasing 100 shares of stock or from an institution buying 10,000 shares. Moreover—and this is a terribly important point—all public investors can participate in any transaction in the auction market to the extent that they are willing to enter better bids than anyone else or succeed in reaching the market before anyone else.

This, very simply, is the auction which is conducted openly, the results of which are immediately reported to the world via the ticker tape. An investor watching the tape can see that his transaction was completed at a price which was the same as, or related to, other prices which preceded his purchase or sale.

This auction, therefore, combines the elements of fairness, orderliness, full disclosure and equal treatment and is designed to do so in a way that builds individual investor confidence in the market mechanism.

Accordingly, the central issue addressed by the bill is whether the orders of public investors in listed stocks should be exposed to all other orders of public investors in those stocks. This is what happens in a public exchange auction market—regardless of whether the investor happens to be a private citizen of modest means or a multibillion dollar institution. This does not happen in the over-the-counter dealer market in listed stocks—in the so-called third market.

The primarily institutional third market has little, if any, individual participation. In that market, an institution typically will sell listed stock directly to a dealer who, in turn, will sell it to an institutional buyer. Conversely, the third market dealer may buy stock directly from an institution and subsequently sell it either directly and privately to another institution, or publicly on the floor of the stock exchange. All of these transactions between dealers and institutions take place in the privacy of the dealer's office—or, if you will, in secret.

This secrecy factor which is a characteristic of dealer markets will continue to prevail even when a consolidated tape becomes operative because disclosure of a trade after it takes place will not change the fact that individual public investors do not have the opportunity to participate in it.

Moreover, dealer markets are in practice less stable than auction markets as explained in my statement. As you know because of the secrecy of third market trading, there is very little publicly available data on the nature and extent of their activities.

Currently, the only publicly available data on third market transactions is based on quarterly reports filed with the SEC, a summary of which is released by the SEC without verification.

These data show, for example, that in the fourth quarter of 1973, total third market trading amounted to 5.4 percent of the share volume and 6.6 percent of the dollar volume of all trading on the New York Stock Exchange.

As you know, the exchange and others have expressed deep concern that the advent of fully competitive commission rates will give broker-dealers compelling reasons of economic self-interest to leave the exchanges and act as over-the-counter dealers in listed stocks. We have repeatedly expressed our great concern that this will trigger an inevitable decline in the quality of the existing exchange auction markets and in the services available to individual investors.

S. 3126 speaks to this concern. The bill provides, as Senator Williams, Senator Tower, and others have said a "fail-safe" mechanism by giving the SEC the authority to require that all trades by broker-dealers in listed securities be effected on registered national stock exchanges if the SEC makes certain findings.

The bill provides that the Commission "shall" adopt a rule prohibiting broker-dealers from effecting transactions in listed securities other than on a national securities exchange. It has been suggested that the word "may" be substituted for "shall," to give the Commission greater latitude in deciding what action to take.

But this would also lead inevitably to a degree of uncertainty that seems inconsistent with the intent of the bill. It seems clear that the public interest supports the preservation of the exchange auction markets as a matter of national policy. If the SEC should decide, however, that some other way of achieving the objectives of a national market system is feasible, S. 3126 allows for such an alternative by providing in subsection (3) that the rule imposed by the Commission "shall not remain in effect after the Commission has determined that a national market system for securities has been established."

Accordingly, we prefer the word "shall," which provides for certainty for the near term without undermining the Commission's authority to decide on an alternative approach, should one be developed, in creating a national market system.

Further S. 3126 does not restrict or eliminate the Commission's authority to take alternative action under various provisions of S. 2519. These would include, for example, regulating dealers, imposing equal rules and regulations in all markets and regulating nonexchange members who bring transactions to the exchanges.

Therefore, the crucial policy question raised by S. 3126 is what, if any, developments should trigger the requirement that all trades in

S. 3126 places the burden of triggering the requirement on the Commission. The Commission must find, after notice and opportunity for hearings, that the fairness and orderliness of the exchange markets or the self-regulatory capabilities of the exchanges have been or are likely to be affected in a manner detrimental to the public interest by over-the-counter trading in listed securities; and (2) no rule of any exchange would unreasonably impair the operations of existing third-market dealers, which would be integrated into the exchange markets, or unreasonably restrict competition in the exchange markets.

While these triggering provisions seem fair, they are also troublesome. Our board believes, and has publicly stated on many occasions, that the public interest would be best served by requiring all transactions in listed securities effected by broker-dealers to be exposed to all other such transactions.

The problem with the triggering provisions of the bill is that they require a determination that the fairness and orderliness of the public auction markets have been—or are likely to be—impaired, in terms of the public interest, before the Commission can act. Understandably, we would like to see action taken before the markets are adversely affected.

Ideally, we would like to see the possibility of damage to the auction market mechanism avoided either by having Congress determine now, as a matter of policy, that it will not be permitted to occur, or by writing specific triggering conditions into the bill which will impose the requirement before any damage can be done to our capital markets.

Obviously, these or any comparable remedial approaches would require a public policy determination by this committee and the Congress.

We recognize, as I stated at the outset, that S. 3126 offers a reasonable compromise solution to the problems we have outlined, and it is for this reason that our board supports the bill. We would not, however, want to see S. 3126 weakened in any way. What I am saying is that if revisions are to be made, we would urge that the bill be strengthened rather than weakened.

Again, on behalf of our entire board, I want to express our appreciation for the time and attention and thoughtful analysis the committee and its staff have given and are continuing to give to this issue.

Mr. Chairman, Mr. Owens has some remarks and with your permission he will proceed.

Senator WILLIAMS. All right.

Mr. OWENS. Thank you, Mr. Chairman.

My name is Cornelius W. Owens. I am executive vice president of American Telephone & Telegraph Co., and a public director of the New York Stock Exchange, Inc.

By way of background, I should add that I served as a public governor of the New York Stock Exchange from 1968 to 1972, and as chairman of the Special Committee on Exchange Reorganization. That committee submitted the basic report which led to the restructuring of the exchange's governing board in May 1972 and I have served since then as one of the exchange's 10 public directors.

I have been continuously and closely involved from the outset in the development of exchange policy with regard to the creation of a national--or central--securities market system. Therefore, I particularly appreciate this subcommittee's courtesy in permitting me to comment on the legislation you are now considering—S. 3126.

I offer these comments not as someone who is involved in the day-to-day activities of the securities industry—but, rather, as a representative of the public who has had the opportunity over the past 6 years to play an active part in determining the policies which govern the New York Stock Exchange.

The importance of preserving and insuring the viability of our capital markets cannot be overemphasized. According to one recent estimate, the capital needs of corporate America between now and 1985 will reach an astounding $3.3 trillion. And I believe that estimate was made without full reference to the capital impact of the current energy situation.

Where is that money going to come from?

Others have documented the fact that corporate America is already heavily in debt. Economists tell us that inflation has severely compressed the value and diminished the prospective role of corporate retained earnings in financing economic growth and expansion.

The business community is becoming increasingly aware that unless the equity markets are able to fill the ever-widening gap between capital demand and capital supply, the Nation may face a serious shortage of capital at a time when it is most desperately needed.

This is the economic environment in which Congress is now preparing to restructure the U.S. equity markets.

The critical question, therefore, as I see it, is not whether the creation of a national market system will help one brokerage firm to prosper or cause another to go out of business--although, obviously, those questions are vital to the firms involved—but the really critical question is whether or not the securities industry overall is going to be healthy enough to play an essential role in helping Corporate America raise the vast amounts of capital needed to maintain and accelerate our national economic progress.

As the capital markets in this country are currently structured, the equity capital needs of America cannot possibly be met without the active participation of millions of individual investors—and a further broadening of the base of corporate ownership. And unless the equity markets are able to operate along lines that will actively encourage rather than diminish individual participation, the approach to a national securities market system could raise serious barriers to achieving the desirable goals identified by Congress.

The success of restructuring the securities markets, then, will depend not on whether the New York Stock Exchange and the rest of the securities industry believe that the best possible job has been done; not on whether the 3,200 listed corporations think the best possible job has been done; and not, even, on whether Congress thinks the best possible job has been done.

The success of the effort will have to be judged, ultimately, by whether or not 30 million or more American investors find themselves in an environment that they regard as hospitable to their investment dollars.

In the past, many companies have been successful in obtaining the use of vast amounts of investment capital from the American people. To a great extent, investors will put their capital at risk in a partic-

ular corporate enterprise because they have for one reason or another confidence in the management and policies which guide that company's activities and because they hope to share in its success.

But there is a much broader element of confidence involved when millions of individuals channel part of their savings into equity investments. That element of investor confidence is firmly grounded in the awareness that the existing securities market system in this country—whatever its imperfections—works for them.

They know that the system as it presently operates—the securities auction market system—is centered in a marketplace where they can buy and sell the stocks of listed corporations, at fair prices at all times.

The stock exchanges have pointed out that the two-way securities auction process—made up of bids to buy and offers to sell—provides both buyers and sellers with the best prices available at a given moment; and the exchanges have correctly stressed that the stock prices generated in this auction process give investors and corporate issuers alike a continuous, accurate overview of what the public thinks those stocks are worth at that particular point in time.

A particular corporation may not be pleased by what that continuing public opinion poll tells it at a given moment—but it does know how favorably or unfavorably its stocks are regarded. And that knowledge is immensely valuable to corporate management in determining both short-range and long-range corporate policy.

When we confront the prospect that a changeover to a dealer-oriented, primarily institutional market must inevitably alienate large numbers of individual investors, we are forced to recognized two very likely consequences:

First, a dealer market system will substantially deprive corporations of the breadth of judgment that keeps them accurately and continuously informed about the supply and demand factors governing trading in their stocks, and that leaves little doubt about what the public thinks of their performance.

And second, a dealer market will force corporations to rely increasingly on the narrow judgments of a relative handful of professional buyers and sellers whose possibly faulty assessment of supply and demand may also be influenced by the State of their own inventories in particular stocks.

If dealer markets proliferate, every listed corporation will have to depend more and more heavily on institutions and other large investors to take up the slack in the supply of investment capital created by the departure of disgruntled individual investors from the market—with all the consequences that implies.

That prospect is not at all encouraging. My own informal conversations with other corporate officials indicate that concern is both widespread and deep.

As a Director of the New York Stock Exchange, I am well aware that certain reservations have been expressed about the validity of the Exchange's warning that a changeover to fully competitive securities commission rates can, in the absence of appropriate safeguards, trigger a chain of events that could have a devastating effect on the securities auction markets and on public confidence in the stock market generally.

I personally find those warnings all too persuasive—particularly

with regard to the likelihood that individual investors will desert the market and that corporations will face the very real threat of institutional domination.

There is, as we all know, a strong tendency in some quarters to distrust bigness in business.

Senator WILLIAMS. Mr. Owens, I regret this but we have to go over and vote. We will recess and return.

Mr. OWENS. I understand.

[Recess.]

Senator WILLIAMS. Now, with a little luck, we can be undivided in our attention.

Mr. OWENS. Thank you, sir.

Senator WILLIAMS. You may resume.

Mr. OWENS. There is, as we all know, a strong tendency in some quarters to distrust bigness in business. At the same time, there is ample evidence to demonstrate that bigness, properly managed and with adequate safeguards, can strongly advance the public and national interest.

As I see it, Congress, in seeking to create a national securities market system, recognizes that this is an area in which bigness and consolidation of vital services can indeed strengthen and improve service to the public. At the same time, there seems to be a paradoxical reluctance, in some quarters, to take the necessary steps to insure that this big national system will operate as effectively as possible.

And I cannot help but wonder—I cannot help but share the concern of many of my colleagues in the corporate community—that this reluctance could, in turn, launch the U.S. securities industry on the road to major desirable improvements with insufficient attention to the perils likely to be encountered along that road.

As you know, it was more than a year ago that the Exchange's board first identified the crucial threat to the auction markets posed by the prospective unfixing of commission rates. At that time, I strongly supported—as did the other public directors—the proposal that concurrently with the changeover all trades of listed securities should be required to take place on registered national securities exchanges.

That proposal is, of course, at the heart of the legislation this subcommittee is now considering. It seems clear to me that you also are concerned that basically sound legislation could inadvertently produce harmful effects. In all frankness, I must add that this evidence of your concern helps to dispel some of ours.

I believe Corporate America would breath more easily and the interests of 30 million or more individual investors would be better served—if the specific safeguards recommended by the New York Stock Exchange's Board of Directors could be written directly into the legislation mandating the creation of a national securities market system.

If that is not possible, then, certainly, the "failsafe" mechanism provided by S. 3126 will at least minimize the likelihood of serious damage to the auction market system, to the corporate capital-raising capability and—most important—to the American investing public.

Mr. Chairman, may I again express my appreciation for this opportunity to present these comments to the subcommittee, and for your courteous attention. Thank you.

Senator WILLIAMS. We're very pleased that you joined us today and made your statement, Mr. Owens.

You mentioned your term: when did your term begin on the board?

Mr. OWENS. 1968—well, on the old board of governors, Senator, 1968. Then I was chairman of the special committee on Exchange reorganization and have been on the board of directors since the new reorganization.

Senator WILLIAMS. Now, Chairman Needham, a couple of questions.

We have been over much ground on this bill with other witnesses. I don't think we have to replow it all.

I would like to know what events would have to occur before the SEC should make its finding of "is likely to adversely affect the fairness or orderliness of the exchange markets." I am looking for your impressions of the kinds of events that would trigger the provisions of S. 3126.

Mr. NEEDHAM. Senator, I think that is probably the gut question here. Of course, our position very simply is that you shouldn't have to go through that agonizing procedure of trying to determine anything. The simple solution really is to require that all trading take place on an exchange; then you don't have to determine whether you want the investing public skewered 5 percent of the time or 10 percent of the time, or 15 percent of the time, which was being suggested earlier.

We feel the best protection is to make—you are asking me what I want, and I am telling you what I think is the best for the investing public. That is to require that all trading take place on an exchange.

Senator, I have been listening to the same dialogs that you have, and no one has given me a reason why we shouldn't do that.

I am not suggesting you should give me the reason, but I have not heard it from the witnesses as to what is wrong with such a requirement.

Senator WILLIAMS. I think the answer to that really is basic to everything we have been talking about. From the members questioning, I get the impression that they want to have that best evidence that there will be—assuming that it is not in the public interest to see the exchange adversely affected in terms of membership with an exodus of some degree—an effective remedy to preserve the auction markets.

They are looking for evidence that there will be an exodus that will change the nature of the auction market, the exchanges, and lead us into more and more reliance on a dealer market.

Mr. NEEDHAM. Well, Senator, I guess the one simple way to do it is to take the existing situation, and let's say, for example, that there is 5 percent of the trading of listed securities on other than a national securities exchange, and as soon as it gets to be 6 percent, you just require everybody to go right back to where they were. It would be that simple. Mr. Calvin feels he would like to make a comment. Would that be all right?

Senator WILLIAMS. Yes.

Mr. CALVIN. Thank you, Mr. Chairman.

This is a question that has been put to a number of witnesses and the simple answer is that there is no precise answer as to what the deterioration is that must take place in the auction markets before they are atrophied to the point where they cease to function in terms of the public interest.

However, we did point out in our earlier testimony on November 13 that if the 10 largest firms of the New York Stock Exchange took the business that they do today on the floor of the exchange back to their offices and acted as dealers, the result would be a decline of 31 percent of the transactions presently handled on the Exchange.

I think clearly that type of a development would lead to the disruption of the fairness and orderliness of the market; as I say, a 31-percent decline in the market transactions.

That would be accounted for by 10 firms moving away from the auction market and becoming dealers, only 10 firms.

So I guess you could observe that it depends on which 10 firms leave. If those 10 top firms leave, and you have a 31-percent decline in activity, clearly the orderliness would be affected.

Senator WILLIAMS. The members were speculating whether you have any evidence that some percentage of firms will leave after May 1, 1975, which is the announced date for the elimination of the fixed rate.

Mr. NEEDHAM. We know that Merrill, Lynch will leave. They have said it.

We know that Goldman, Sachs has said it; we know Paine, Webster has said it. We know that there will be tremendous pressure on the so-called institutional type firms to leave.

There will be no incentive for them to have their blocks taken down to the floor. So I think we are dealing with a very real situation. That is why when you ask me what should the criteria be, I say that is a very complicated question, and the better choice is to avoid the question, and the determination, and to enact it the way we suggested.

Senator WILLIAMS. Now, finally, would you deal with this disparity of regulation between the exchanges and the third market, and whether this disparity leads to any hard speculation of the effect on incentives to leave the exchange?

Mr. NEEDHAM. Yes. I will deal with that.

Let's deal with—and we can break it down into parts. The parts that I forget, Mr. Calvin will remember.

Let's talk about market-making responsibility. We have rules at the NYSE, requiring the specialists to make an orderly market. They have to be there every day.

In the third market there is no comparable regulation.

Second, we have rules governing the way the transaction takes place, and the way they are reported. Ultimately there will be the composite tape, but there will not be any surveillance—there is no surveillance at this moment of what goes on in the dealer market.

The NASD does not regulate the dealer markets the way we regulate the floor of the New York Stock Exchange, or the way that Midwest and PBW do it.

So they can move away from the market and not be there. They are just free of all the rules that we have about dominating the market as dealers.

So that everyone has been talking about the last couple years, anyway, about the need for uniform rules and regulations

As you know, I personally believe these initiatives should start in the private sector. We arranged such a meeting at the exchange a couple months ago to see if we couldn't get people to start to work on this project of developing uniform rules and regulations. We had that meeting and a third market firm that was represented there was disruptive and unwilling and was an obstructionist, to any progress in the area of developing uniform rules and regulations.

So as a result of that, we had then to turn to the Federal Government and say we just can't get anyone to agree because of the obstructionist attitude of this one particular individual, so we have turned the problem back to the SEC.

So we have tried at the New York Stock Exchange to develop uniform rules and regulations. It isn't that we say all these rules must be the rules for everybody, but there has to be a starting point and we offer to sit down and talk with people about those rules on the basis of their merit.

Maybe we would end up discarding some of ours which might be considered anticompetitive or unduly restrictive in the context of a national market system. But we couldn't even get off first base with it.

Senator WILLIAMS. This is within the industry now?

Mr. NEEDHAM. That's right.

Senator WILLIAMS. What is happening in the area of equal regulation, either as a result of your efforts or the Commission's efforts?

Mr. NEEDHAM. The Commission wrote us a letter last August, saying they would see to it that there would be rules on short selling, antimanipulative practices, and on suspension of trading.

Nothing much has happened at the Commission since that letter came to us. But we have received assurances from time to time that the Commission was going to do something in the way of developing those rules. But nothing much has happened.

Senator WILLIAMS. I missed that——

Mr. NEEDHAM. We have received assurances that the Commission would develop those rules, but they never have.

Senator WILLIAMS. If there were equal regulation, where it is possible and desirable, would that change the picture concerning incentives to leave the exchange?

Mr. NEEDHAM. It would lessen it. It would lessen it. I still feel, Senator, that we are dealing with such a complex issue here that we ought to have a fail-safe device. It doesn't cost anything to have it. Certainly the SEC, who will make the administrative decision, will be qualified to make that decision and I just can't see any injury coming about as a result of it. It is a latent authority in the act if enacted which the SEC will use at the appropriate time.

Senator WILLIAMS. All right.

Mr. NEEDHAM. You know, Senator, may I——

Senator WILLIAMS. At any rate, the whole scene changes after the rates are freely competitive and we have the central market apparatus. Then the whole thing changes.

Mr. NEEDHAM. That's correct.

Senator WILLIAMS. So we are talking about an interim period.

Mr. NEEDHAM. Precisely.

Senator WILLIAMS. You were going to say something?

Mr. NEEDHAM. Yes, sir.

Many times, Senator, people have said that the New York Stock Exchange is trying to retain its monopoly position. The statement was made earlier this afternoon by a member firm of the New York Stock Exchange with respect to that.

The New York Stock Exchange is not a monopoly. But you know, it is interesting. One of the fears that has been expressed is that if this proposal that you have here in the form of this bill were to be enacted, it would force a third market firm out of business.

Senator, nothing could be further from the truth.

I have in front of me—let me just identify it for the record. It is identified as a prospectus and the number is W–258000 Weeden & Co., filed with the SEC January 17, 1973, received by the SEC office of records, January 19. It deals with the various employee plans of that firm.

Senator, it shows under sales and income on page 10 a comparison for the years 1968, 1969, 1970, and for the 9-month periods in 1970 and 1971 and I assume the numbers have not changed that much, it shows that this firm which is a major third market firm derived approximately—and it is difficult for me to read the numbers because of the photocopy—but it looks to me like about 39 percent of the gross revenues from its third market activities.

Now, it is inconceivable to me that you, the SEC, or we would write such rules that they had to get out of that business totally. But even if we did, it wouldn't put them out of business.

Let's take an analysis of Weeden & Co.'s income statement for the year 1973 and for the benefit of the record this is its annual report to stockholders for the year ended September 30, 1973. On page 5 of that report it shows for the year ended 1973 and 1972 securities sales—unaudited—and it shows the gross. I assume their net of $16 million in 1973, of which $5 million have to do with corporate stocks, one-third of their business.

Now, we don't know whether they are making markets in over-the-counter stocks. You know, there is little available on what a particular third market firm does. That doesn't indicate to me that they are going to go out of business. They are very creative people, they have told us, and I am sure they know how to adapt themselves to uniform rules and regulations that would be imposed on them through the central market system.

Now, I have an ad which is going to be introduced as evidence later on in this hearing put out by the same firm and interestingly enough, Senator, this firm does—they show breakdown of our volume by customer, for example; approximately—it is 19.9 percent of their total share volume is done on exchanges in the United States. So, this third market firm is utilizing the exchanges right now. So, what is the great hardship on the third market to require that they show their trades because of the other—the balance of their trading activity we assume is out of their dealer inventory directly to a bank, a mutual fund or other institution as they show it.

What is so contrary to the public interest to say to them—and we're not saying they have to become a member; we're saying "Take those orders down to a floor of a national securities exchange." We don't care where it is; they are members of every exchange except New York and American Exchange, and we are asking them to show those orders

to the crowd and to the book and clean up the public book. That is in the public interest. Why don't they want to do that?

Senator, they do business on the New York Stock Exchange, they say 2.7 percent of their transactions for their own account.

Well, Senator, we have an arrangement as the result of an edict by the SEC where we have to give nonmember broker dealers a 40-percent discount as long as they sign an agreement with us. That agreement has been signed by approximately 1,500 nonmember broker dealers. This third market firm hasn't signed it. That means that when they come on the floor of the New York Stock Exchange, they pay the full nonmember commission.

Now, it is a publicly held company. They have the opportunity to buy these stocks at a lower price but they are paying a higher price than they have to. They are not availing themselves of this discount.

Now, Senator, a number of questions come to my mind. Why would someone do that?

Senator WILLIAMS. You are not speaking to stock prices now. Rather, you are saying that they have the 40 percent commission discount available to them?

Mr. NEEDHAM. They get the same prices: it is the commission that is different.

Why would some firm want to do that?

I can conjure up a lot of reasons. These are reputable people. But one of the reasons could be that they don't want to subject themselves to our regulation which is what all of the 1,500 other people do. The others sign an agreement giving us the authority to examine their books and records.

Another reason might be that they are involved in extensive reciprocal practices with our own members where they meet them on other exchanges or cut them in on underwritings or something like that, and it gets washed out.

I am glad Senator Biden is back—and I put this question to you simply—I am concerned, I don't want to see the American public skewered 5 percent of the time or 10 percent of the time. I just would like someone to get on this record the answer to the questions I have just posed. I am sure there are answers to them and maybe after I have heard the answers I will understand it and won't be as concerned about it as I am right now. But I cannot understand why this proposal is being considered anticompetitive.

We're not asking them to join the exchange: we are not asking them to subject themselves to our regulation. They can still be subject to some regulation the NASD is presumably enforcing.

Why won't they do it? Why won't they cut the little guy in on their business? They are an institutional firm and that's it, pure and simple. Why won't they let the small guy participate in their business? That is the question that this subcommittee has to get an answer to and no other.

Senator WILLIAMS. We will probably get it after we answer that bell in just about 45 minutes.

Mr. NEEDHAM. OK.

VOICE. Forty.

Senator WILLIAMS. Did you say 40?

Thank you, very much.

Senator Biden?

Senator BIDEN. In your opinion, what series of events are there that would be required for the provisions of S. 3126 to become operative?

Mr. NEEDHAM. On the presumption that you are not willing to buy my argument that all trends ought to be there now, then I would say to you there is only one answer to your question.

Senator BIDEN. That is your present argument. That is the most recent one.

Mr. NEEDHAM. That is right. That is the public interest question. All you have to decide is how many times you want the public to be skewered.

Senator BIDEN. I assume that is the question that moved you from your previous position?

Mr. NEEDHAM. Well, we moved to it in the interests of getting some type of failsafe device, right.

I would say to you to cut it very simply, that given uniform rules and regulations and given the opportunity for third market firms of all types and descriptions to participate in the ordinary flow on any exchange that they want which we're willing to do, at least at the New York Stock Exchange, then I would say that if the percentage went from 5 to 6 percent I would move if I were a Commissioner of the SEC.

Senator BIDEN. That is a very specific answer; thank you.

With previous witnesses, I have asked the question whether negotiated rates will cause a flight from trading on the floor of exchanges to the third market. Do you think that will happen?

Mr. NEEDHAM. As a businessman, you have to say yes to that, Senator. The reason is very simple. The profit opportunities as a dealer are much greater than they are as a broker. This third market firm I am referring to here, and this is Weeden and Co. again in their annual report to their shareholders said that third market profits in 1973 were approximately equal to 1972 even though share volume decreased from the prior year.

Now, Senator, I can tell you that the member firm community of the New York Stock Exchange lost $49 million last year principally in the securities commission income aspect of their business. So, here this is—this is clear, indisputable fact that the dealer market is more profitable than an agency market. That is why the firms will leave.

Senator BIDEN. There have been firms that have indicated to you, I suspect, that they would leave.

Mr. NEEDHAM. That is right, and I mentioned them before, Senator. There were Merrill Lynch, Goldman-Sachs, Paine Webber, several of the institutional type firms.

Senator BIDEN. Can you tell me how recently that was indicated to you?

Mr. NEEDHAM. Since the middle of December, Senator, when the committee and subcommittee marked up S. 2519.

Senator BIDEN. Well, I am probably being provided information that is incorrect, then, because in rereading the testimony of Mr. Weeden prepared for presentation later today, he quotes, and I don't know what the date on this is, such firms as Goldman-Sachs as saying that that is not the case; they wouldn't leave. I guess—is that just a matter of dates? Is that why that is?

Mr. NEEDHAM. What you have in front of you is an adversary brief. In preparing an adversary brief, you are entitled to a great deal of

license. You are allowed to pick and choose the information you have in there. That is what you have there. You have statements made by people away from the dates I have just spoken about.

Senator BIDEN. I realize it is an adversary brief, but it is a direct quote. It was made under oath in an adversary proceeding which I have a little more faith in than some of our hearings which are not adversary enough in my opinion.

So I guess your explanation is, and I shall direct your answer to Mr. Weeden when he testifies, that even though there is a date on this testimony, it is apparently now the case that the statement of Goldman-Sachs is no longer operative.

Mr. NEEDHAM. You have to read the pages preceding and the interrogations of the—I think those are quotes from the Thill case, right?

Senator BIDEN. Right.

Mr. NEEDHAM. You have to read that record carefully and I suggest you have the staff do that because you may find the interrogations went one way and the answers were responsive to the question being asked, but not necessarily responsive to the question you are asking.

Senator BIDEN. It seems to me it is hard to misunderstand. "I have rejected the view and do not now believe that the advent of fully negotiated commission rates would be likely to cause my firm to leave the New York Stock Exchange—" no matter what preceded or what followed it.

Mr. NEEDHAM. Senator, Mr. Levy and Mr. Reagan are both members of the board of directors of the New York Stock Exchange; they were members of the board of directors on March 1, 1973. It was on that date that this policy was articulated for the first time by the board.

So, any of those statements if they precede that date I would say they are inoperative and inapplicable.

Senator BIDEN. I guess the easiest thing for me to do, since we have pointed out an apparent contradiction, is to ask directly those gentlemen, for example, Mr. Reagan of Merrill Lynch.

Mr. NEEDHAM. Because of your great interest in this, I would like to interrupt a moment.

I mentioned earlier when you were not here that you don't have to leave the exchange to have the event occur that we're concerned with here. Without this legislation, it would be possible for Merrill Lynch; you know they are a holding company, it has a variety of subsidiaries. It could have one subsidiary which would be a member of the New York Stock Exchange, and it could have a subsidiary that was not a member of the New York Stock Exchange, and that subsidiary could deal in the third market, wheel and deal just the way they wanted to while the other subsidiary would be subjected to our rules.

Do you follow me, Senator?

Senator BIDEN. Yes; I do, and I assume that if your statement is correct that would in part explain the apparent inconsistency that puzzles me. Here is another example: in a letter dated March 21, 1974, from William Salomon of Salomon Bros. to Senator Hart, Mr. Salomon says, and I quote, "Finally we have stated that we have no plans to resign our exchange membership after the advent of fully negotiated rates and have expressed disbelief that there would be a mass exodus of other exchange members. We still hold these views."

Now, that was March 21.

Mr. NEEDHAM. March 21 of this year?

Senator BIDEN. March 21, 1974.

Mr. NEEDHAM. I would say this, that if Billie Salomon said that March 21, he meant it.

Senator BIDEN. That is a definitive statement; thank you. I knew I would get some definitive statements.

Mr. NEEDHAM. Well, you wanted a more adversary proceeding, Senator.

Senator BIDEN. Well, I don't know how we can really interject this. I just got a note from Staff. "Merrill Lynch's representative has just come over and he insists," and it is underlined, "that their position is they will not leave the exchange." But we can find that out. We can get that in writing, I guess, by asking them that question.

But you have answered how you think that is sort of a red herring.

Mr. NEEDHAM. Is he on the board of directors?

Senator BIDEN. I don't know, but if he is wrong, he certainly won't be.

As I understand it, you really see no threat to the competitiveness of the securities industry if the third market were to be eliminated, or, in other words, if they were forced to effect transactions on the floor of the exchange. Is it your position that this would not in any way affect either the public interest or the interest of those who are involved in the industry other than third market firms that had to move?

Mr. NEEDHAM. Senator, we would love to have the third market firms become members of our exchange because they are in their own way competitive. They do have capital. That is the one thing they do have. The whole industry needs capital and to bring all that capital into one place has to result in a more liquid market. We would be in favor of that.

Senator BIDEN. I asked Chairman Garrett's opinion on some rules yesterday and I would like to ask your opinion on a couple if I could.

Rule 113, which prohibits specialists from dealing directly with certain kinds of customers. Could you comment generally on that?

Mr. NEEDHAM. Rule 113 as you may know, Senator, is a rule that was adopted by the New York Stock Exchange. The American Exchange's counterpart of the rule is 95. This was at the request of the SEC in order to make certain that the specialists did not become involved in certain antimanipulative types of activities.

It stemmed from the investigation, the Rey investigation of what happened at the American Exchange.

Now, the important part of that is not the generalization of the rule itself but that the rule has resulted in a structuring of the industry which seems to be acceptable to the members of the industry and it also seems to serve the public interest well.

Now, a lot of people are concerned that the third market firms who currently can make markets and then talk to the institutions, if they were subjected to rule 113 that that in effect would deny them some type of competition.

Well, I have two responses to that. First of all, the member firm community is going to have to alter some of its practices as well so it shouldn't be that the third market firm should escape reformation as well.

The second point is simply this: Weeden & Co., and I will come back to them because they are the only ones that publish ads like this, their profile of the breakdown of their volume by customer indicates to me that their profile is comparable—could be the same as the profile of any of our upstairs firms like Salomon Bros., Bear Stearns, or Goldman Sachs. Twenty percent of the activity of Weeden & Co. is done on the stock exchange. So, Weeden and Co. could have the ability if they were members or had access to the exchange, to conduct their business in the same fashion that they are conducting it now.

The only difference, Senator, is that they would have to bring their trades to the floor of the New York Stock Exchange and clean up the book which is what Goldman Sachs does, and Mr. Salomon's organizations does.

The unanswered question is, why won't the third market firms let the investing public, the little guy get in on those trades?

Senator BIDEN. Your concern for the little guy is admirable. So, Weeden & Co. could have the ability if they were A.T. & T.

Mr. OWENS. Right. I agree with you, Senator.

Senator BIDEN. Which is refreshing to know, you know.

How about rule 438, which prohibits dealers other than specialists from quoting a two-sided market.

Mr. NEEDHAM. I will let Mr. Calvin answer that one, if you don't mind, Senator.

Mr. CALVIN. Rule 438 is no problem at all in the context we are talking about. There are many other rules that would have to be addressed but this isn't one of them.

All this rule does is it says a member organization cannot advertise in quotation sheets. I don't know that that's any type of a problem at all in the context of integrating the third market and the exchange market. If it were, I am sure the rule would be revised or if the SEC would allow us to do so, would be repealed. It is just not a problem.

Senator BIDEN. How about the fact that memberships to the Exchange are available only on a medallion basis? I assume if this legislation went into effect, and the determination was made that it is time to implement it, the exchange would expect third-member firms to come in on a paying basis, is that correct?

Mr. NEEDHAM. Senator, I think the third market firms would be willing to pay their way. I have never heard them say they were not willing to pay.

Senator BIDEN. What if they did say that?

Mr. NEEDHAM. The problem is the seat, right? The House bill, H.R. 5050, clearly envisions, as does the SEC policy statement, that all broker-dealers, all eligible broker-dealers shall have access to the central market system.

Now, Senator, no one, I guess, really understood what that meant until recently. What that means is that the seat concept is eliminated, so in terms of the national market system there is no necessity for anybody to buy a seat any longer.

The problem we have, Senator, which Congressman Moss addresses, and I know Chairman Williams as well does, is how we reimburse the seatholders for their equity. That is a separate problem. We are working on it without much success.

Senator BIDEN. That is what I thought.

Mr. NEEDHAM. The bill does not require the third market firms to become members at all.

Senator BIDEN. I understand that. But yesterday I believe Commissioner Garrett indicated that if the Williams' bill were to be passed and the mechanism were triggered that something would have to be done about providing for the movement to the exchange without having to come up with the cash.

Mr. NEEDHAM. Senator, I don't know why the Commission arrives at this so late in the game. When I was a commissioner—and that seems like a hundred years ago ago—we dealt with that problem. We said it very clearly that there wasn't going to be an entry fee other than the usual initiation type fees and user type fees. The real problems—and I will state it again for the record—is what do I do about the equity which our members have at the present time, which amounts to $16 million? But that is not at issue here. This bill doesn't require they become members. All they have to do is bring their trades to the floor.

Senator BIDEN. If I understand you correctly, your position is that first of all they should be required to be there anyway regardless of this bill. You see no reason why the third market exists in the State that it now does nor should it.

You would like to see them members of the exchange.

Mr. NEEDHAM. Senator, in May 1971 before this committee cranked up its hearings, before the House cranked up its hearings, before the SEC did, I gave the whole world for what it was worth a blueprint of what the securities industry should do—how it should be restructured. All of this legislation is taking you right down the road of that blueprint.

Senator BIDEN. That is what the third market is telling me..

Mr. NEEDHAM. But the difference is, Senator, I reached that as a commissioner. At that time I had integrity. The point is——

Senator BIDEN. A noble admission.

Mr. NEEDHAM. Anything that fragments the securities markets of the United States ipso facto is detrimental to the public interest. That is the way I came out as a Commissioner; that is the way the Exchange board of directors came out.

Senator BIDEN. You view the existence of the third market as a fragmentation?

Mr. NEEDHAM. It's existing right now as, yes.

Senator BIDEN. So you know the basic premise from which you start is that they shouldn't exist because they are fragmenting the industry now and that they therefore should be members of the exchange.

Mr. NEEDHAM. Senator they should exist, the firms should exist.

Senator BIDEN. But not in the present format.

Mr. NEEDHAM. The third market shouldn't exist.

Senator BIDEN. That is right.

Mr. NEEDHAM. The record may not show it as clearly as I'd like it to. The last time I appeared here you asked me a question about the fourth market whether they should be required to be part of the national market system. I answered negatively because at that time we didn't think it was a problem.

But, Senator, that question has been haunting me for 4 months and you have convinced me the fourth market should be part of it.

Senator BIDEN. I thought you might come around to that. I really did. It really does my heart good to know that I can move you like that. But again for the record, am I correct that your basic premise is that the existence of the third market is by definition a fragmentation of the securities industry, consequently they should be members of the exchange?

Mr. NEEDHAM. And ultimately part of a national market system.

Senator BIDEN. Right, which are exchange markets, the way you view it.

Mr. NEEDHAM. Technically.

Senator BIDEN. Within the context of exchanges. So that secondly as I understand it would say that the fact of movement from fixed commission rates to negotiated rates barring any other action being taken is going to have the effect of further fragmenting the industry by moving people from the exchanges to the third market as it now exists.

Mr. NEEDHAM. That is correct, Senator.

Senator BIDEN. OK.

Now, you then go on to say that, if I understand you correctly, that the triggering mechanism of S. 3126 would become 5 to 6 percent of the trades now executed over the exchange were moved to the third market.

Mr. NEEDHAM. Absolutely. I gave you three points to start with.

Senator BIDEN. Okay. I appreciate that. In addition, you see this 5 to 6 percent decrease as inevitable. That is just a fait accompli as far as you are concerned.

Mr. NEEDHAM. That is right.

Senator BIDEN. So what you are saying now is that there is no question that the third market will be eliminated if this bill is passed.

Mr. NEEDHAM. That is not quite right.

Senator BIDEN. Wait a minute now. Tell me how it is not quite right.

Mr. NEEDHAM. Because if the bill goes through the way it is, I don't know what the SEC—what determination the SEC will make.

Senator BIDEN. I see. That is a good point.

You would like to have the bill tightened as I recall from the beginning of your testimony, to insure that their version would be coinciding more with your version of what would constitute the need to exert the trigger.

Mr. NEEDHAM. When I buy life insurance, I don't want the life insurance company telling me you are insured 95 percent of the time.

Senator BIDEN. I understand that. I want 100 percent and the insurance you want is elimination of the third market and you see this as a vehicle of being able to do that.

Mr. NEEDHAM. And also to make sure—as a result of this legislation plus S. 2519—that whatever noncompetitive or anticompetitive rules the New York Exchange may have will in the process be eliminated, so no one will be hurt——

Senator BIDEN. I understand your motivation is pure and pristine and to help the little guy and I know——

Mr. NEEDHAM. It isn't just pristine, no——

Senator BIDEN. But I want to make it clear, that your support of this bill, coupled with your language, is directed and has as its sole purpose the elimination of the third market. I want to make no mistake about that, and I want to make it clear for the record. You said we want to eliminate the third market; we missed it last time out and we will get it this time.

Senator BIDEN. I think it is important that that be stated.

Mr. NEEDHAM. I just want the record to show that you stated what you thought I said.

Senator BIDEN. OK, well, I think that reasonable men reading the record will have no mistake about what you said. But then again, you know, the reasonable man is becoming as scarce as Diogenes the honest man around here, so I don't know.

Mr. NEEDHAM. Senator, you recognize the bill as presently drafted does not do what you say it does.

Senator BIDEN. Well, it may not do assuming that the commissioners don't agree with you as to what constitutes the need to trigger the bill.

Mr. NEEDHAM. That is——

Senator BIDEN. But if they believe as you did, and if it's as inevitable as you say, then they end up where you do. But you will be able to take the record at a later date and say that that is not what you meant to say and I agree it is my conclusion being drawn from what you have said.

Mr. NEEDHAM. Senator, I just want to make something clear. I assume the line of questioning is designed to evoke answers from me and doesn't necessarily indicate your convictions because if I believed that the convictions—that the words you have just uttered were your convictions then I would have great difficulty trying to understand why any member of this committee voted for the national market system bill because that is a bill that is designed to eliminate fragmentation. I am opposed to fragmentation; the committee is opposed to fragmentation; how you express that I leave up to you.

Senator BIDEN. Let's talk about fragmentation for a moment.

If I own half the pie and you own half the pie, it is fragmented. If I want your half to be coupled up with my half on my table we are bringing it back together. If you want my half coupled up with your half on your table we are bringing it together, too. We have a central pie, all whole and full. It all depends on whose table it is on.

Mr. NEEDHAM. No, Senator, you don't understand the securities markets.

Senator BIDEN. You are right about that, I guess.

Mr. NEEDHAM. If you give me 5 minutes, I will make it absolutely clear to you as to what we are saying.

Senator BIDEN. The chairman has been very kind to me——

Senator WILLIAMS. It is all right with me, Senator Biden, as long as you stay through all the people that are left.

Senator BIDEN. I will ask one last question of Mr. Owens.

Mr. NEEDHAM. OK, you are the Senator. I think——

Senator BIDEN. Only for another 4 years though.

Mr. NEEDHAM. That is about the time my contract expires.

Senator BIDEN. Mr. Owens, you also expressed the need for providing the best advantage for trading by individual investors to promote depth and liquidity in the securities markets and that these are best represented in the exchange auction markets.

Did I understand your testimony?

Mr. OWENS. The general sense, yes.

Senator BIDEN. I am told, however, that your own company, A.T. & T., has an employee program which allows them to buy and sell A.T. & T. stock directly from the third market firms; is that correct?

Mr. OWENS. No; we do not buy from the third market as such. We have a reinvestment plan with respect to the share owners and they purchase stock and we purchase stock for them and they get the stock.

We have a savings plan whereby the—one of the choices is to buy A.T. & T. stock.

Now, where that is purchased, I don't know.

Senator BIDEN. OK. Thank you. You gentlemen have been very responsive. I appreciate it.

[Complete statement of Mr. Needham follows:]

STATEMENT OF THE NEW YORK STOCK EXCHANGE, INC.

My name is James J. Needham. I am Chairman of the Board of Directors of the New York Stock Exchange, Inc. With me today are Cornelius W. Owens, a Public Director of the Exchange, and Donald L. Calvin, Vice President.

Mr. Owens, in addition to being one of our most distinguished Directors, is Executive Vice President of the American Telephone and Telegraph Company. He has been a member of the Exchange Board since 1968 and headed the Special Committee whose report led to the 1972 reorganization of the Exchange's governing structure. Following the conclusion of my remarks, he will offer some further brief comments on the need for this legislation.

We are pleased to have the opportunity to appear at these hearings to express the support of the Board of Directors of the New York Stock Exchange for S. 3126.

May I say at the outset that we appreciate the concern shown by the entire Committee in this matter of appropriate safeguards for public trading on the nation's stock exchanges—and particularly by Chairman Williams, by the Bill's cosponsors, Senator Alan Cranston and Senator Bill Brock, and by the entire staff.

When the provision which is now S. 3126 was under consideration as a possible amendment to S. 2519, the Exchange's Board had an opportunity to review it in depth. At that time, the Board took the position that while the proposal did not go as far as the Board would have liked with respect to preserving the securities auction markets, it did represent a fair compromise which merited the Exchange's support. Our position today is the same.

Rather than restate the concerns which we presented in great detail to this Subcommittee in our appearance at hearings on S. 2519 last November,[1] I would like to focus today on the essential public-interest aspects of this issue.

At the heart of S. 3126 is the public policy determination that it is in the vital interests of more than 30 million American investors to preserve the public exchange auction markets in this country.

There is near-universal agreement on this point. Senator Williams stressed it when he introduced the National Securities Market System Act on the Floor of the Senate last October. The hearing record on that Bill is filled with specific affirmations by the SEC and by representatives of the securities industry.

The SEC, in its March, 1973 white paper on the "Structure of a Central Market System," stated "the Commission's commitment to the preservation of an auction-agency market rather than a purely 'dealer market' for listed securities." The SEC added, "Perhaps it is worthwhile to state again, unequivocally, that the Commission does not wish to encourage the creation of a purely dealer market for listed securities."[2]

[1] The Exchange's testimony before the Subcommittee on Securities on November 13, 1973 is included in the hearing record on S. 2519 on pages 165 to 517.

[2] Policy Statement of the Securities and Exchange Commission on the Structure of a Central Market System, page 24.

Treasury Secretary George P. Shultz, as recently as January 29, stressed the close dependence of investor confidence on the maintenance of fair and efficient securities markets.[3]

And the recent Treasury Department Report, "Public Policy for American Capital Markets," in a sense expanded on Secretary Shultz's remarks.[4]

It is perhaps also pertinent to recall here Chairman Williams' succinct statement of the objectives of S. 2519 when he introduced that Bill on the floor of the Senate last October 2.[5]

Mr. Chairman, the texts of the various comments to which I have referred are footnoted for the Subcommittee in my prepared text

In addition, I would note Chairman Williams' comment to the Senate on March 6 when he described S. 3126 as "a major piece of securities legislation which will go a long way toward speeding the development of a central market system and *bolstering investor confidence in the markets*." (Emphasis added)

The SEC has underscored the fact that the element of public confidence so vital to individual participation in the securities markets is not well-served by dealer markets. Consider this illuminating description of a dealer market from the Commission's March 1973 white paper:

"Presumably, the classic example of a dealer market is the over-the-counter market, in which it is virtually impossible for an investor's order to be executed without the participation of a dealer in the transaction. There is no facility whereby public orders can offset each other, except under the auspices of a market maker, and this rarely occurs. Since the intervention of a dealer involves an additional spread between the prices at which investors can buy and sell, it is likely that in many instances investors obtain less favorable prices on their trades than if they could trade with other investors."

By contrast, the advantages of a public exchange auction market may be demonstrated by describing simply how transactions are handled on a stock exchange.

In an exchange auction market, all public orders are treated fairly—with the first order received at the best price receiving priority over other orders. This is so regardless of whether that order is from an individual investor purchasing 100 shares of stock or from an institution buying 10,000 shares. Moreover—and this is a terribly important point—all public investors can participate in any transaction in the auction market to the extent that they are willing to enter better bids than anyone else or succeed in reaching the market before anyone else.

This, very simply, is the auction which is conducted openly, the results of which are immediately reported to the world via the ticker tape. An investor watching the tape can see that his transaction was completed at a price which was the same as, or related to, other prices which preceded his purchase or sale.

This auction, therefore, combines the elements of fairness, orderliness, full disclosure and equal treatment and is designed to do so in a way that builds individual investor confidence in the market mechanism.

Accordingly, the central issue addressed by the Bill is whether orders of public investors in listed stocks should be exposed to all other orders of public investors in those stocks. This is what happens in a public exchange auction market—regardless of whether the investor happens to be a private citizen of modest

[3] "The general objective of public policy is to have markets that operate in a fair and efficient way. Fairness and efficiency lead to confidence on the part of the investing public that returns will be reasonably related to risks, that the institutions through which they deal have financial integrity, and that the individual investor is not at a serious disadvantage compared with the institutional investor." Address by Secretary Shultz, United States Saving Bond Campaign Luncheon.

[4] "All evidence suggests that the proportion of Americans investing directly in common stocks and other corporate securities is much greater than the proportion of any other country. The New York Stock Exchange is by far the largest organized capital market in the world, and the other American exchanges and the over-the-counter market are relatively large and active by comparison with most foreign markets. For approximately 50 years, New York has also been the leading center of international finance.

"The characteristics of the American capital markets which have produced these results are numerous, but among the more important are the fact that investors feel that they can buy at the lowest available price and sell at the highest available and the fact that the generation and flow of relevant information is relatively rapid, accurate, and complete." Treasury Department Report. *Public Policy for American Capital Markets*, page 1.

[5] "First, the maintenance of stable and orderly markets with maximum capacity for absorbing trading imbalances without undue price movements. And second, centralization of all buying and selling interests with appropriate protection of public orders. In this way every investor will be assured of receiving the best possible execution of his order, regardless of where it originates."

means or a multi-billion-dollar institution. This does not happen in the over-the-counter dealer market in listed stocks—in the so-called third market.

The primarily institutional third market has little, if any, individual participation. In that market, an institution, typically, will sell listed stock directly to a dealer who, in turn, will sell it to an institutional buyer. Conversely, the third market dealer may buy stock directly from an institution and subsequently sell it either directly and privately to another institution, or publicly on the floor of a stock exchange. All of these transactions between dealers and institutions take place in the privacy of the dealer's office—or, if you will, in secret. This secrecy factor—a characteristic of dealer markets—will continue to prevail even when a consolidated tape becomes operative because disclosure of a trade after it takes place will not change the fact that individual public investors do not have the opportunity to participate in it.

Moreover, dealer markets are in practice less stable than exchange auction markets. When stock prices are rising, dealers can be expected to step up their market-making activities. However, when stock prices are declining, dealers are free to close up shop in those issues since, unlike stock exchange specialists, they have no obligation to maintain orderly markets. As dealers refuse to make markets, stock price instability is intensified and down markets become more severe.

This is substantially what happened during the recent price decline in the dealer-oriented corporate bond market, where market-makers simply turned their backs, reducing the overall amount of capital devoted to market-making and severely damaging liquidity.

Recent studies of the NASDAQ quotation system have shown that this same type of "fair-weather" market-making is common in the present over-the-counter market in both listed and unlisted stocks. It is also demonstrable that dealers generally choose to make markets only in the most active listed stocks, again since they have no obligation comparable to that of exchange specialists also to handle less active issues.

Also, because of the secrecy of third market trading, there is very little publicly available data on the nature and extent of their activities.

Currently, the only publicly available data on third market transactions is based on quarterly reports filed with the SEC, a summary of which is released by the SEC without verification.

These data show, for example, that in the fourth quarter of 1973, total third market trading amounted to 5.1% of the share volume and 6.6% of the dollar volume of all trading on the New York Stock Exchange.

As you know, the Exchange and others have expressed deep concern that the advent of fully competitive commission rates will give broker-dealers compelling reasons of economic self-interest to leave the exchanges and act as over-the-counter dealers in listed stocks. We have repeatedly expressed our great concern that this will trigger an inevitable decline in the quality of the existing exchange auction markets and in the services available to individual investors.

S. 3126 speaks to this concern. The Bill provides, as Senator Williams, Senator Tower and others have said, a "fail-safe" mechanism, by giving the SEC the authority to require that all trades by broker-dealers in listed securities be effected on registered national stock exchanges—if the SEC makes certain findings.

The Bill provides that the Commission "shall" adopt a rule prohibiting broker-dealers from effecting transactions in listed securities other than on a national securities exchange. It has been suggested that the word "may" be substituted for "shall," to give the Commission greater latitude in deciding what action to take. But this would also lead inevitably to a degree of uncertainty that seems inconsistent with the intent of the Bill. It seems clear that the public interest supports the preservation of the exchange auction markets as a matter of national policy. If the SEC should decide, however, that some other way of achieving the objectives of a national market system is feasible, S. 3126 allows for such an alternative by providing in sub-section (3) that the rule imposed by the Commission "shall not remain in effect after the Commission has determined that a national market system for securities has been established."

Accordingly, we prefer the term "shall," which provides for certainty for the near term without undermining the Commission's authority to decide on an alternative approach, should one be developed, in creating a national market system.

Further, S. 3126 does not restrict or eliminate the Commission's authority to take alternative action under various provisions of S. 2519. These would include, for example, regulating dealers, imposing equal rules and regulations in all markets and regulating non-exchange members who bring transactions to the exchanges.

Therefore, the crucial policy question raised by S. 3126 is what, if any, developments should trigger the requirement that all trades in listed securities be effected on the national stock exchanges.

S. 3126 places the burden of triggering the requirement on the Commission. The Commission must find, after notice and opportunity for hearings, that (1) the fairness and orderliness of the exchange markets or the self-regulatory capabilities of the exchanges have been or are likely to be affected in a manner detrimental to the public interest by over-the-counter trading in listed securities; and (2) no rule of any exchange would unreasonably impair the operations of existing third market dealers, which would be integrated into the exchange markets, or unreasonably restrict competition in the exchange markets.

While these triggering provisions seem fair, they are also troublesome. Our Board believes, and has publicly stated on many occasions, that the public interest would be best served by requiring all transactions in listed securities effected by broker-dealers to be exposed to all other such transactions.

The problem with the triggering provisions of the Bill is that they require a determination that the fairness and orderliness of the public auction markets have been—or are likely to be—impaired, in terms of the public interest, *before* the Commission can act. Understandably, we would like to see action taken before the markets are adversely affected.

Ideally, we would like to see the possibility of damage to the auction market mechanism avoided either by having Congress determine *now*, as a matter of policy, that it will not be permitted to occur, or by writing specific triggering conditions into the Bill which will impose the requirement before any damage can be done to our capital markets.

Obviously, these or any comparable remedial approaches would require a public policy determination by this Committee and the Congress.

We recognize, as I stated at the outset, that S. 3126 offers a reasonable compromise solution to the problems we have outlined, and it is for this reason that our Board supports the Bill. We would not, however, want to see S. 3126 weakened in any way. What I am saying is that if revisions are to be made, we would urge that the Bill be strengthened rather than weakened.

Again, on behalf of our entire Board, I want to express our appreciation for the time and attention and thoughtful analysis the Committee and its staff have given and are continuing to give to this issue.

Senator WILLIAMS. Thank you, gentlemen.

We call now Mr. Aaron R. Eshman, Mr. Arthur B. Durkee, Mr. Joseph R. Neuhaus, and Mr. Lawrence S. Black. Are you gentlemen all masters of synthesis? I hope so.

Senator BIDEN. Gentlemen, would you identify yourselves and proceed in any manner in which you can agree upon?

STATEMENT OF AARON R. ESHMAN, STERN, FRANK, MEYER AND FOX, INC.; ARTHUR B. DURKEE, STERNE, AGEE & LEACH, INC.; JOSEPH R. NEUHAUS, UNDERWOOD, NEUHAUS AND CO.; AND LAWRENCE S. BLACK, BLACK AND CO.

Mr. DURKEE. I want to assure you that it was made up some time ago before I heard anybody else's testimony.

Senator BIDEN. There is no way you can anticipate the testimony, of course. I can't even anticipate the answers to the answers. Thank you. Go ahead.

Mr. DURKEE. I am Arthur Durkee and I am executive vice president of Sterne, Agee, and Leach, Inc., of Birmingham, Ala. with branch offices in Montgomery and Mobile, Ala. We are members of the New