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RULE 394: 120-HOUR COUNTDOWN

Address by Francis J. Palamara
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When I accepted the invitations from Jean McNamee and Bill Craig to meet with you today, I had some slight hope that the Securities and Exchange Commission might issue its long-awaited decision on the future of stock exchange off-floor trading rules earlier this week. I had hoped, too, that the decision might add some extra flavor to our industry's observance of the Thanksgiving holiday. Unfortunately, however, we will all have to wait at least until Monday to know the outcome of the SEC's deliberations. But after many months of uncertainty about the ultimate fate of New York Stock Exchange Rule 394 -- and similar rules of other stock exchanges -- I guess we can manage to be patient for another 120 hours or so.

At the same time, I don't think there is any way to overstate the importance of the impending decision. NYSE Chairman Jim Needham, for example, has pointed out that the SEC will rule, in effect, on "how securities are going to be traded in this country in the future: How they will be priced -- and by whom; how they will be bought and sold -- and by whom."

Of course, that isn't exactly the way Congress put it to the SEC. Formally, Congress charged the Commission with determining whether the off-floor trading rules of stock exchanges constitute an "undue burden on competition." In arriving at a decision, the SEC really has three main options:

It can find that the rules do not impose an undue burden and, therefore, should be left substantially as they are.

Or, it can decide that the rules are anticompetitive and should either be eliminated or drastically changed.

Or, finally, the Commission can decide that even if it thinks the rules are anticompetitive, in some ways, they produce countervailing public benefits which justify retaining them with, perhaps, some constructive modifications.

It is, frankly, the third of those alternatives that would seem to be most consistent with what is generally known about the Commission's views. As far as NYSE Rule 394 is concerned, we doubt it will survive into 1976 -- and, as a matter of fact, our Board of Directors has already taken formal steps to consign that particular rule to history. But more about that a bit later.

THE KEY TO THE DEBATE

The key word throughout the long debate on off-floor trading rules has been "competition." Often, there have seemed to be almost as many definitions of competition as there have been participants in the debate.

Now, I believe most Americans would generally agree that the opportunity to compete fairly is an indispensable element of the private enterprise system in this country. Most of us would also agree, I believe, that the ability to obtain and exercise an unfair competitive advantage is very much out of phase with our concepts of private enterprise.

Part of the problem the securities industry has had to face, therefore, is a strong and understandable reluctance on the part of government to sanction almost anything that has been characterized -- justly or unjustly -- as "anticompetitive." These days, if you want to attract a crowd, all you have to do is toss out that single epithet, "anticompetitive." So it wasn't surprising that when the SEC announced that it would hold public hearings on off-floor trading rules, in October, there was a ready-made audience.

In fact, however, the show turned out to be much less sensational than some people expected. There was very little ranting and raving about the big, bad stock exchange villains -- and quite a bit of thoughtful, rational comment from deeply concerned witnesses who had obviously done their homework on the issue.

To be sure, there were one or two who made it clear that they would be delighted to have a chance to dance on the exchanges' graves, regardless of the consequences for anyone else. But they were familiar performers who trotted out the familiar arguments that splintering the securities markets into scores of independent dealerships would really generate all kinds of wonderful new competition and save investors all kinds of money.

PROTECTION -- NOT PENNIES

Some of the steam began evaporating from that argument when a representative of an organization called Shareholders of America told the SEC that individual investors were more interested in the protection afforded by a stable, closely regulated market than they were in the remote possibility of occasionally saving a few pennies on a transaction in some other kind of market environment.

In any case, as a starting-point for meaningful deliberation about competition in trading securities -- and particularly with respect to how securities are and should be priced -- it is necessary to recognize that we have an element of competition in the securities industry that does not really exist elsewhere. Competition in the securities business involves more than the circumstance of two or more providers of services striving against one another for the business of customers. Competition here also involves the simultaneous ability of the customers to compete in determining the prices at which they buy and sell stocks.

A BURDEN ON WHOM?

Accordingly, any question of whether particular rules do or do not impose "an undue burden of competition" must also ask -- On Whom? And any consideration of changes in particular rules must determine whether a theoretically commendable effort to enhance competition among securities industry professionals may have the thoroughly reprehensible effect of imposing unfair competitive burdens on investors generally -- or on specific groups of investors.

The reason some 95 per cent of all transactions in listed stocks take place on registered stock exchanges today is that exchange rules generally require member brokers to expose all orders in a particular stock to the flow of all other orders in that stock coming to the same exchange. The resulting interaction of most of the existing supply and demand for each stock is crucial to determining the fair market price of each stock at any given moment.

The nature of the auction process -- in which the highest bid and the lowest offer normally get the trade -- also enables an exchange to require that orders from smaller-scale investors must be given the opportunity to participate in large block trades. This element of "displacement" enables individual investors to obtain the benefit of prices that may otherwise be unavailable to them because the large block trades -- which are often pre-arranged for institutional customers -- must also be exposed to the full flow of orders coming to the exchange before they can be executed.

A PROTOTYPE RULE

We have said many times in the past -- and it cannot be repeated too often -- that the rules governing these procedures are, in fact, the cornerstone of the auction market system. To the extent that a central or national market system can be said to exist in this country today, these are the enabling rules.

As many of the witnesses at the SEC hearings pointed out, the ultimate national market system that Congress has called for will also need an effective rule or rules to channel the full flow of eligible orders into that system -- to prevent large buyers and sellers from taking trades outside the system whenever that may suit their purposes. At the Exchange, we can find no logic in the idea of discarding a prototype rule -- and vaporizing the benefits that flow from it -- when you know that somewhere not very far down the road you would face the almost impossible task of re-assembling the concept and putting it back into effective operation in order to activate a Congressionally mandated new system.

Obviously, before any rule can be determined to be good, bad or otherwise, it is necessary to examine the benefits it produces.

DEALER METHODS

A key benefit of the auction market system -- and, thus, of even the present off-floor trading rules -- is that it provides the unique opportunity for offsetting public orders to meet in the trading crowd on an exchange floor. And in fact, nearly 75 per cent of all trades on the New York Stock Exchange involve such a meeting of public orders. The opportunity for the public's orders to be executed within the specialist's quotation spread -- without the specialist's intervention -- simply does not exist in a non-exchange, or dealer, market where the dealer participates for himself on one side of every trade, and where every trade is executed at <u>his</u> -- the dealer's -- bid or offer price. Since dealer intervention necessarily involves a spread between the price at which he will buy from a customer and the price at which he will sell to a customer, investors usually obtain less favorable prices on trades with a dealer than they do when they trade with other investors.

There are additional considerations. An auction market basically is an agency market. The customer is represented by a broker -- by a professional, if you will -- who does his bidding, competing against other professionals to get the best price for him. A dealer, by contrast, stands in an adversary relationship to the customer, setting the price at which he is willing to buy or sell and, in effect, offering the customer a simple take-it-or-leave-it option.

Very interestingly, a well-known critic of off-floor trading rules was asked this question at a recent symposium conducted by the National Bureau of Economic Research:

"Do you assert that there is no responsibility to seek out a better market if you are acting as a dealer in.../a/...stock?"

His reply, in effect, was that his firm's dealer activities precluded acceptance of such responsibilities unless a customer specifically asked the firm to act as an agent in handling an order.

Large institutional investors, because of their great bargaining power -- and because they, too, are professionals, in a very real sense -- typically have little trouble adjusting to dealer-market conditions. Individual investors and smaller institutions, however -- whatever their particular sophistication -- simply do not have any comparable leverage and resources. This has already proven to be the case with so-called "competitive" commission rates which have chiefly benefited the largest institutional investors.

The impact of the recent rate change cannot be shrugged off. With competitive rates squeezing much of the profit out of bringing orders to the exchanges, the elimination of effective off-floor trading rules would impel many exchange member firms to abandon the agency business and set up dealer subsidiaries to execute trades away from the trading floor. And, in fact, a number of major firms have made it clear that they would find it advantageous to take such a course. Our most pessimistic scenario envisions a domino effect propelling exchange specialists into independent dealer operations -- thereby accelerating the erosion of the existing trading mechanism for many hundreds of moderately active and relatively inactive stocks.

MARKET RESPONSIBILITY RULE

But while the Exchange has vigorously opposed elimination of off-floor trading rules, we recognize that the existing rules are not perfect. We believe it is possible to have more effective rules pending the development of a national market system which, in the view of almost everyone concerned, will have to have some comparable rule to assure that orders in eligible stocks flow into that system.

Last month, the Exchange's Board of Directors approved a new Market Responsibility Rule to supersede Rule 394. The new rule preserves the essential features of auction market trading in listed securities -- and the key public benefits of the exchange auction market system which I have outlined -- while eliminating the complicating features of Rule 394 to which some critics have objected so strenuously. Essentially, the new rule would simplify the procedures for taking a trade off the Exchange when a member broker has reason to believe that might be in the best interests of a customer. Many of the individuals and organizations testifying at the recent SEC hearings suggested, as a matter of fact, that if the SEC feels compelled to change the existing rules, this would be the most appropriate way to go about it -- without risking disruption of a smoothly functioning system. This new Market Responsibility Rule is now before the SEC. And, in fact, the Commission could, if it chooses, resolve the entire issue by approving the new rule.

WINNERS AND LOSERS

What all of this boils down to, I believe, is that elimination of effective off-floor trading rules probably would work to the advantage of a limited number of securities dealers and to the largest and most strongly capitalized stock exchange member firms which could profitably re-orient their activities to so-called "upstairs" market-making in the most active listed stocks. Advantages would also accrue to large -- primarily institutional -- investors with powerful price-bargaining capabilities. The largest corporate issuers of stocks would probably suffer the least disruption of their markets.

On the other side, the likely losers would be corporate issuers of less actively traded stocks for which the markets would probably become less orderly; smaller securities firms -- including a great many of the regionals -- which could neither survive the erosion of the brokerage business nor assemble the huge amounts of capital needed to start over as dealers; and, above all, the vast majority of individual and smaller institutional investors who lack the financial clout to combat dealer-imposed prices or compete against the largest and strongest institutional investors.

The significance of any decision to encourage the proliferation of dealer markets in listed stocks was summed up very concisely by Dr. Juanita Kreps who is Professor of Economics at Duke University and a Public Director of the New York Stock Exchange.

A DEVASTATING IMPACT

Writing in The Washington Post, Dr. Kreps said: "With the individual investor ill-equipped to compete in such an environment, trading and ownership of the major corporate stocks would come to be totally dominated by the largest investors.

"The effect on public confidence in the U.S. securities markets," she added, "would be devastating; and the impact would reverberate throughout the economy. If millions of individual investors believe that a new undue burden of competition deprives them of the certainty of being able to buy and sell stocks at fair prices, whenever they choose and without being disadvantaged by the 'big guys,' they will retreat from the stock market and from active ownership of American business.

"And no amount of elegant theorizing about competition among professionals," Dr. Kreps concluded, "will stop them."

It is generally assumed that a major exodus of individual investors from the market is already underway. We will know much more about that within the next few days.

As many of you probably are aware, the New York Stock Exchange has periodically examined the size and composition of the American shareowner population. Back in 1952, the estimated number was a mere 6½ million. By 1970, our sixth "Census of Shareowners" estimated that the total number of Americans who owned stock had soared to nearly 31 million. Two years later, an admittedly less authoritative, purely statistical estimate boosted that figure to 32½ million -- and at least one irreverent smart-aleck suggested that sooner or later there would be more shareowners than people.

SEVERAL MILLION DROPOUTS

Since 1972, however, the trend has turned downward. The computers have already begun spinning out the basic statistics of a new "Census of Shareowners" -- the seventh in the series. And we are not at all optimistic about what the figures will show. In fact, we anticipate confirmation of the widely held belief that several million shareowners have dropped out of the picture.

Well, you may say, things have been bad all over for a long time -- particularly in the stock market. In addition to being discouraged by declining prices, many of those people probably had to sell their stocks to keep up with spiraling living costs or, in more extreme cases, to help tide themselves and their families over while they were out of work. And in any case, does it really matter whether 20 million or 30 million or 50 million people own stocks? At the Exchange, we happen to believe it matters a great deal -- and not just because the majority of those people are customers of our member firms.

One reason our shareownership estimates attracted so much attention in the past is that, for nearly 20 years, they clearly documented growing popular involvement in this nation's basic economic processes. Obviously, a decline in shareownership now will be widely viewed as a reversal of the advance of economic democracy.

I believe, therefore, that any examination of what is going on in the securities business today must recognize that many of the issues we are dealing with involve the well-being of 25 or 30 million or more individual Americans who believe in our economic system and who almost certainly want to continue to be a part of it.

One of the key issues for the entire investing public is, of course, the matter of investment-related taxes. This is an area in which the federal lawmakers have shown a shocking lack of sensitivity to the needs of their constituents -- and to a great many hard economic realities.

Many of you may be familiar with the series of capital studies published by the Exchange over the past year. Those studies documented the threat of a massive capital formation problem for American business in the decade ahead. One of our principal conclusions is that U.S. corporations will have to raise an average of $23 billion a year in new equity capital alone between now and 1985. That annual sum is more than double the amount raised in 1971 -- the peak year for equity financing by non-financial corporations.

The prospect is that a large equity capital gap will develop in the context of an over-all national capital deficiency. We project that the national demand for capital could outstrip the available supply of savings by some $650 billion through 1985. As Jim Needham pointed out to the Joint Economic Committee of Congress last week, a major capital deficiency could conceivably force a downward reorganization of the nation's economic priorities -- accompanied by increasing unemployment and inevitable serious political and social repercussions.

NEEDED: CHANGES IN INVESTMENT TAX POLICIES

Our studies make it abundantly clear that if U.S. corporations are to raise the vast amounts of equity capital they will need for modernization and expansion, there will have to be some dramatic changes in public policy aimed at stimulating investment -- primarily by individuals. And that means significant tax reform -- not at some unspecified time in the future -- but now.

The Exchange has been pressing for major tax reform for a long time. When we speak of tax reform, we mean, simply, that the federal government has got to stop treating investment profits as if they were the product of sin -- and investment losses as if they were a just punishment for trying to earn a profit.

Without going into minute detail, here are the major elements we believe merit serious consideration in formulating the kind of tax policies and incentives that will help reverse the tide of declining shareownership and bring individual investors back into the market in force:

First, we believe a portion of corporate divident payouts -- say, 25 per cent -- should be deductible from taxable corporate profits. Most corporations would probably divide their tax savings between additional retained earnings and additional dividend payouts. Whatever the actual distribution, any marked increase in actual dividend payouts would have a healthy impact on stock prices, simplifying the corporate task of floating new stock issues. And even a moderate change in this part of the tax structure would help deter many corporations from relying as heavily on debt financing -- and fully deductible interest payments -- as they have in recent years.

Second, we believe it is essential to adopt a sliding tax rate for capital gains, with frequent, gradual downward changes in the percentage of a gain that is taxable -- and to roll back the maximum tax rate on capital gains to the pre-1970 limit of 25 per cent.

We also believe a major stimulus to individual investment would be provided by establishing a $1,000 capital gains tax exclusion for individuals, when total gains do not exceed 25 per cent of earned income.

Further, we believe a start should be made toward correcting the current absurd treatment of capital losses -- by raising the deductibility allowance from $1,000 to $5,000 and returning to full deductibility of long-term losses.

We have also recommended that stock commissions be treated as a deductible expense in the year in which they are paid -- rather than adding them to the cost basis when ultimately realizing a gain or loss.

We believe something should be done to encourage foreign investment in U.S. equities. The most obvious starting-point would be to repeal the existing withholding tax on dividends paid to foreigners. At rates up to 30 per cent, this tax has stood as a major barrier to foreign investment.

Finally, we are looking at new ways to encourage corporate employees to invest in the companies that employ them. Too many plans today reflect a fringe-benefit concept that gives the employer a tax benefit for making stock purchases available to employees. We think it may be more to the point to give the tax incentive directly to the employee who elects to dip into his or her own savings in order to participate. There are a number of ways in which that might be accomplished -- and we are convinced that it is essential to stimulate employees to take an active, personal financial interest in the productivity and profitability of their corporate employers.

CRANKING UP NEW RULES

I suggested, at the start of my talk, that we had begun a 120-hour countdown to the SEC's decision on off-floor trading rules. My watch shows me that we're almost down to 119. And I suspect that some of you may want to fire some questions at me. But before you do, I'd like to touch briefly on two additional related issues that are of particular concern to the analysts' fraternity.

Earlier this year, it looked as though the government regulators were going to further complicate life for the U.S. business community by cranking up a whole new set of rules dealing with earnings forecasts. One of the few bits of good news we've all had in recent months is that the SEC, responding to a heavy wave of adverse comment from the corporate community, is taking another look at its own proposals.

As some of you may be aware, the New York Stock Exchange was in the front ranks of vigorous objectors to the proposed rules. We did assure the SEC of our full support for the objective of moving toward fuller and more meaningful disclosure of pertinent information to shareholders -- an area in which the Exchange itself has spearheaded many changes over the years. Our objections centered on the belief that the complexity and vagueness of the rules proposed by the SEC could have precisely the opposite effect. That is, the kind of rules that were being proposed could, we strongly believed, lead many corporate managements to bend over backwards to avoid making any statements at all that might be construed as projections -- so as to remain outside the burdensome proposed reporting requirements. Obviously, that route would diminish -- rather than increase -- both the quantity and the quality of communications between management and investors, to the benefit of no one.

AN EVOLUTIONARY APPROACH

It would certainly seem that the SEC has been alerted by the business and financial community's comments to the importance of taking a more flexible and -- as we put it in our own letter to the Commission -- a more evolutionary approach. We suggested, too, that the scope and nature of the needed revisions would require redrafting and re-exposure of the SEC's proposals. And while the Commission has not indicated what modifications it may consider, neither has it denied that the entire concept of earnings forecasting rules may need to be thoroughly rethought in terms of what is practicable and what is not.

The problem of reconciling commendable theoretical objectives with the facts of life in the real business world has recently surfaced in connection with another aspect of corporate responsibility to the investing public. I'm referring now to the superficially attractive notion that corporations ought to disclose, through their financial statements, what they are doing to help improve the environment and how they are discharging their social responsibilities.

This was another instance in which inappropriate methods were being advocated as a means of achieving goals with which few responsible Americans would quarrel. Improving the environment and developing high standards of social responsibility are certainly objectives worth pursuing. Our basic problem with the proposal that the SEC establish rules and financial reporting procedures as a means of acquainting investors with the activities of individual corporations in these areas was threefold.

First, investors have shown little interest in basing investment decisions on the environmental and social activities of corporations; second, the absence of uniform standards for reporting such activities would almost certainly aggravate existing problems that the accounting profession is trying to solve with respect to developing generally uniform rules and standards; and third, most of the information that would be disclosed under the proposed rules is already required to be disclosed under various federal, state and local regulations -- and adding still another reporting burden would accomplish little in the way of improving the flow of significant information to shareowners and investors.

The net effect, as we suggested to the SEC, would be to satisfy the wishes of certain special-interest groups without adding anything of value to the existing body of knowledge -- a very dangerous kind of precedent to establish.

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I seem to have ranged pretty widely over many of the major issues that have been absorbing most of our time back in New York. If there is a common thread running through all of these issues, it is the conflict between attractive -- often superficially attractive -- theory, and what goes on in the real world.

The theory of strengthening competition among securities industry professionals -- against the reality that changes in the competitive environment could lead to a more concentrated industry in which far fewer people would have an opportunity to compete on the allegedly better footing.

The theory that a broad base of individual shareownership of public corporations is a key factor in the system of private enterprise capitalism that has made this country economically strong -- against the reality that our federal tax structure seems almost deliberately weighted in ways that discourage people from investing.

The theory that maximum disclosure of every conceivable type of corporate information would assist investors in making sound decisions -- against the reality that the wrong kind of disclosure rules could actually deter corporations from disclosing as much information as they might want to.

Malcolm Forbes recently offered a very pungent assessment of this problem of theory versus reality. And although his comments were directed particularly to the securities industry's experience with competitive commission rates, I think they can be applied with equal validity to many of the other things that have been happening.

"As is endlessly the case," he wrote, "good intentions are producing bad results...When the current savage shakeout is over, the biggies will be bigger than ever...there will be less competition, less liquidity, and less of most of the things well-intentioned reformers had in mind."

At the New York Stock Exchange, a big part of our job involves trying to keep constructive reform moving at a reasonable pace along a track that can lead to something better -- rather than to something worse. It isn't always easy -- but then, as all of you ladies and gentlemen know, nothing in this crazy, wonderful business is.

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