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POST 390 - ORDEAL OR OPPORTUNITY*

Remarks of
Junius W. Peake**

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The First National Bank of Chicago
One First National Plaza
Chicago, Illinois 60670

**Senior Vice-President
R. Shriver Associates
120 Littleton Road
Parsippany, N.J. 07054

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*Together with a synopsis of The National Book System
by Junius W. Peake, Morris Mendelson and R.T. Williams, Jr.

POST 390 - ORDEAL OR OPPORTUNITY?

Today I would like to discuss with you some of the problems and opportunities which I believe lie ahead for the securities industry.

The last decade has seen massive changes in the industry. When living through change, it appears slow. Only in retrospect can we appreciate the speed and magnitude of the restructuring which has occurred.

The next decade will bring a series of new changes which will make the recent events appear tame by comparison. There will be more trauma, uncertainty and conflict. However, there will also be tremendous opportunity for profit. This profit will be reaped by those within the industry who can anticipate the changes, take advantage of them and most importantly, contribute to the constructive reordering of our business.

I shall address the important issues in sequence, as I view them, beginning with the key issue in the National Market System. This issue is the survival of the traditional role of broker <u>and</u> dealer within the same organization.

Much has been written and more said about the internalization of order flow and its importance to market making. There is a widely held belief that in a "390-less" world and an amorphous concept called a National Market System, agency functions will diminish, if not vanish. In addition, so goes the assertion, vast sums of capital will be required to be employed by all remaining broker/dealers as market makers so they can compete and attract agency order flow to survive in the world of the future.

These beliefs and assertions have no basis in fact within a properly constructed National Market System. A significant characteristic of a properly designed system will be its ability to provide for <u>total</u> interaction of <u>all</u> orders, whether those of market makers, or of customers entered via their agent brokers. If <u>system-wide</u> priorities of price, and time of entry within price, obtain, all orders will compete with all other orders, and market making may be viewed separately as a profit center, divorced from the agency function. Broker/dealers may select to be agents, market makers, or both, secure in the certainty that their professional skills, rather than their size or location, will be the measure of their success or failure. The only system with this characteristic is known by various names: The National Book System (Peake-Mendelson-Williams), the Merrill Lynch system, the Weeden WHAM or the "hard CLOB".

Any system other than one which assures system-wide time/price priority for each order will (1) force flow, size and location to be essential criteria for success and profit, (2) be more costly, (3) be far less efficient and (4), evolve eventually into a hard CLOB.

There is a regulatory method which can alternatively force the centralization of order flow. This method is to segregate the broker/dealer function. Presented as an anti-overreaching rule, it would prohibit a broker/dealer from acting as principal in any agency order he receives from certain classes of customers. This forces the broker to enter the agency order into a system which will assure that a competitor will interact with his hard-earned order, if no customer order on the other side matches, even though the originating broker may have a better bid or offer at the moment.

Segregation of the broker/dealer function was the subject of extensive hearings in 1934. The public policy determination then was that both functions could be retained without harm to the investor. To provide de facto segregation in the name of centralization of order flow will cause potentially mortal injury to the industry. If it is wrong to deal with a customer as principal in listed stocks, doesn't it follow that it is worse to do so over-the-counter? That would be the next prohibition. Later corporate and municipal bonds would be added. Finally, underwriters would be separated from brokers. The industry would be totally restructured.

If there is to be a segregation of the broker/dealer function, and I don't believe there need be, it should come only after the Congress reverses its earlier determination and as the result of extensive hearings which clearly show the public benefit. We should not back into such a regulatory scheme without a specific Congressional mandate.

On the other hand, the Commission cannot and should not permit the creation of a market system in which brokers must be large to be successful. Agency orders must not have an "added value" when received in large numbers. A hundred agency orders should be worth, in the National Market System, only one hundred times a single agency order. If they are worth more, there will be an economic incentive to be large. The only two methods which prevent this incremental value of order volume are: (1) the segregation of the broker/dealer function which we have already discarded, and (2) the development of a market in which there is system-wide time/price priority for each order. In such a system, the first bid at a price will always be executed if the security trades at that price. This assures that best execution is guaranteed on each transaction, whether the contra side is an agency or a market maker order. There will be no premium for bigness.

In the present over-the-counter equity business, a large national wire house has certain advantages over a smaller firm. In the absence of a specific buy or sell recommendation, for example, the order flow for the top 50 to 100 OTC stocks, while discontinuous as to the time of the arrival of buy and sell orders, should tend to even out over the course of a trading day. If a stock is 20-1/2 in level 3 of NASDAQ, a large firm may buy from its customer at 20 less commission, and sell to another at 20-1/2 plus commission. At the end of the day if there is a modest long or short position, the firm will probably close it with another wire house with an opposite position, thus becoming even.

Order flow thus is important now in the over-the-counter market. Real market making, in order to narrow spreads, to act as jobber, or to provide needed additional liquidity is minimal. In the National Market System, all eligible securities, including most OTC stocks, should trade under the same time/price priority rules. It will be possible to sell as principal to your retail or other agency customer only if your market maker order is entered at a better price or is already the first order in the system at the best price. Order flow will thus be incidental to market making, and a competent firm, such as a regional broker/dealer, will be able to select securities in which it chooses to act as market maker by reason of underwriting relationship, research interest or local character.

A firm in Kansas City will be able to compete with large institutional or wire houses on an order by order basis. Since there will be complete order interaction, size and location of the firm will not be important, either in the agency or market making function.

A National Market System should provide incentives for broker/dealers and others to invest in the market making function. Presently, such incentives are either a monopoly franchise, as held by New York Stock Exchange specialists, or the opportunity to see and to interact with a portion of agency order flow, such as an over-the-counter market maker, by advertising in NASDAQ.

A properly designed National Market System will have the best attributes of both exchange markets and over-the-counter markets, and none of the shortcomings of either. It will be a substantial improvement over both of its predecessors, but will not be an exchange or an over-the-counter market.

Presently, exchange market makers abide by affirmative and negative obligation rules which are alleged to provide a greater amount of price continuity and liquidity than a market system without such a franchise holder. Most specialists do well financially. They do so in their market making activities by having access to almost all, if not all of the order flow. A specialist almost never generates agency order flow; he just interacts with it. Under a hard CLOB, <u>all</u> market makers will interact with <u>all</u> order flow. Markets will be better, and spreads narrower.

The over-the-counter market maker presently acts within a rule which says he must be a continuous two-sided market maker in his selected securities on NASDAQ. This rule is impossible to enforce. A current over-the-counter market maker uses his advertising as a <u>market maker</u> to attract the flow of inquiries which permits him to trade as a wholesaler at a hoped-for profit. Under a National Market System he will be free to select any security in which to make markets, confident that he will see all orders, and can interact as he chooses.

In the system of the future, the incentives which will be offered for market making should create an environment which will encourage the market maker to take actions which promote an efficient and liquid market, rather than to "order" him to perform acts which will, if carried out according to the letter of the rules, occasion economic loss, if not bankruptcy.

In this regard, it is important to remember that capital should be encouraged to enter the National Market System arena <u>in total</u>, rather than to specify the securities in which to be committed. Capital should seek profit.

Certainly, stocks like General Motors or American Telephone and Telegraph will need relatively little, and infrequent, market making. However, when they do require market making capital, it will probably be needed instantly and in large amounts. Under a system which requires registration as a market maker <u>by security</u>, rather than <u>as a class of broker/dealer</u>, capital may not be available when and where it is needed. Market making capital should only be used to narrow spreads or to add liquidity, rather than to make "riskless" principal transactions.

How can this environment be created? I suggest that market making be encouraged by a series of rules which will provide incentives. These rules should encourage market makers to:

1. Commit the greatest amount of capital to the market making function consistent with safety to the National Market System, and an adequate rate of return to the dealer.

2. Take simultaneous long and short positions of approximately equal dollar value in different securities, so that the market makers will be able to provide liquidity on downward movements, and have an available supply of inventory to sell in rising markets. Both kinds of transactions will dampen price movements. In addition, an approximately equal long and short position will minimize the dealers' overall market risk. Profit will be made on the spread, not market movement.

3. Turn over their inventory at a rapid rate. If this encouragement is not present, brokers may misuse their market maker status by making term investments in their market maker accounts. This practice is an abuse of the present specialist system. Market making should fill in temporary disparities within the order flow, and add liquidity.

4. Use options wherever possible, which will permit market makers to hedge their positions and to provide needed inventory and liquidity to the options market.

Without being specific at this time, both capital and margin rules should be drafted which will achieve the four objectives enumerated above. These should not be difficult to write.

How will this change impact present market participants? Certainly a market system of the sort suggested earlier will remove some from their favored positions. On the other hand, it will provide the "fair field of competition" called for by the Congress. Only a person or firm unsure of their ability to survive in a competitive environment will object to a system like this. The privilege and monopoly aspects of the securities industry are fading away. They will inexorably and inevitably vanish, and with them will go the specialist system.

I will comment briefly on the use of a hard CLOB for the trading of options. Presently there is an inability for the industry to add to new options products because the trading of overlying options and the underlying stocks cannot properly be surveilled. The instantaneous audit trail, order by order, transaction by transaction, available only in a hard CLOB, will eliminate the abuses which have led to a moratorium in the options market. If you wish to restart growth of options trading, a National Book System will get you underway.

From Here to There

The next major topic is "how do we get from here to there?" One first step to analyze the present facilities. One test of the quality of a facility is to ask yourself, "If it were to be burned to the ground, would I build it the same way again?"

Let us look at the present facilities for the secondary trading of securities. They are two centuries old in concept, have multiple trading arenas, monopolies at the center, and employ armies of people who spend most of the day rushing about in cavernous rooms yelling at each other and scattering tons of scribbled paper on the floor. Yet, despite this scene of chaos, we boast that we have the most efficient pricing mechanism in the world.

I question whether a single person in this room today would rebuild the securities markets exactly as they presently exist. Certainly no systems designer would. A systems designer would analyze the functions to be performed, determine user needs and then select an appropriate technology to accomplish the objectives.

National Market System Characteristics

Let me briefly list some characteristics of the National Market System.

First, it should be able to bring all buy orders together in competition with each other, and all sell orders into competition with each other.

Second, it should employ auction principles, enabling orders to interact with other orders, without unnecessary dealer intervention.

Third, it should enable dealers to compete in the market making process. This will narrow spreads and permit a more efficient pricing mechanism.

Fourth, it should be cost effective, providing service to all users at at an economic price.

Fifth, it should be a fair market place, permitting competition on an equitable basis by investors of all types as well as dealers.

Sixth, it should be financially secure. This characteristic implies that it will be well-regulated from a financial standpoint.

I could add more characteristics, of course, but these will do for a start. Let us examine the present system to see how it measures up.

The present market system does not bring together all orders and market maker bids and offers. Multiple exchange floors, coupled with third market makers, make total order interaction an impossibility. In over-the-counter securities, there is no limit order book, thus requiring dealer transactions in almost all cases.

The present market system, does employ some auction principles. However, size takes precedence, and later orders arriving in a crowd are treated with parity with those already in the book. In addition, third market maker bids and offers do not have an opportunity to interact with the orders on exchanges. Finally, the existence of multiple exchange floors renders the auction principle of time/price priority futile.

The present market system does not permit all dealers who wish to do so to compete in the market making function. Physical location, franchises, and restrictive rules inhibit fully competitive market making. This lack of competitive market making is the most serious deficiency of the present system.

The present market system is not cost effective. Independent studies estimate potential operating savings ranging upwards from $100 million annually if replaced by automated facility.

The present market system is not equitable, since certain participants such as specialists are treated more favorably by rule in some areas, and less favorably in others. Also, large orders take size precedence over similar priced orders of smaller size.

The present market system <u>is</u> financially secure, although its lack of cost effectiveness will eventually put a severe financial strain on its participants, thus weakening the integrity of the system.

By the criteria I have enumerated, we should not, if it were to burn down, rebuild our system. We would build a better one.

Why are we having such difficulty getting to a better system?

The answer lies in the unique political structure of our industry. We permit the operators of the present market mechanism to make policy and to evaluate the merits of a possible successor system which they will not, in all probability, control.

Let me make an analogy, although I recognize that analogies are often dangerous. Let us assume that the Pony Express had been in business for 200 years, rather than for the eighteen months it really was. New communications technology had sprung up all around it, but the horse and rider were still king.

Let me further suggest that the Congress passed a law which said the communications industry should use new technology to improve service. However, the users, the senders of messages, looked to the operators of the Pony Express Companies to set policy. You can imagine what happened. The Express Company heads decided that the solution was to use modern technology to link -- that word always receives a lot of attention — to link the Express Companies! This they called IME - Inter Message Express. Now users of the service would know where the rider was - say between Hannibal and Fulton, Missouri. They would not use the system to replace the horse and rider. You appreciate the ridiculousness of this situation. However, this is exactly where the securities industry is today.

We have new technology, we have a law which says we should use it, and we have an existing set of market facilities. However, instead of the users — the broker/dealers doing a public business and performing a market making function -- developing the new system, they are waiting politely for the very group which doesn't want a new system to develop it.

Where then, may you ask, are the industry leaders? I hope there are more than a few in this room. To paraphrase a famous quote, "For inefficient manual systems to triumph, it is only necessary that good brokers do nothing". I hope the leaders in this room start to develop a National Market System.

Here today are industry leaders who, working together and independently can guide the building of a National Market System. What is wrong with a little independence? Why do you have to wait to see what the exchanges will do? Will you regain control over the market mechanisms? If not, I suggest respectfully that when the off[illegible] trading restrictions are lifted, as lifted they will be, and you do not have a workable National Market System in place, don't blame the exchanges. Blame your [illegible]. You will have a series of obsolete floors linked together with the modern technological equivalent of rubber bands. Therefore, the IME type system will not work and will not last. The hard CLOB will inevitably be constructed, at greater cost and effort.

The battles which will remain to be fought after the implementation of a National Market System are the battles which will be most important. As I see the industry's future, the next conflicts will revolve around the following issues:

First, the 11(a) issue, the separation of money management from brokerage. It is interesting to observe, as a footnote to the legislative history of this issue, that institutional membership, which so many were fearful would result without such a prohibition, has become a non-issue as a result of the institutions' economic access to exchanges because of competitive rates.

Second, the issue of appropriate compensation for research. Soft dollars, like a soft CLOB, are transient at best. This issue used to be political in nature, but is now strictly business. At some point in the near future, I predict, brokerage firms will offer their institutional research for hard dollars. If the research product is not saleable to institutions at a price which will return a fair profit, it should be abandoned. A collective sigh of relief probably will be the result either way. I can't imagine why many brokerage firms are still seeking unprofitable institutional agency business. Market share does not necessarily equate to profit.

It is almost tragic that many of the principal proponents of the "paying up" clause for research have closed their doors or merged. I conjecture that if they had opposed the clause as vigorously as they supported it, they would probably still be in business today. They would be in business not as broker, but as a purveyor of research, free from the troubles of a National Market System and with hard dollars to show for hard work.

Third, an extremely important issue, is the question of the future method of compensation for underwriting. As we know, with fixed compensation arrangements in underwriting fees, the give-up is back. Human nature is not subject to a lot of change, and when underwriting compensation becomes competitive rather than fixed, as it surely will, the industry should not be surprised. If there is enough cushion in the amount of underwriting or selling fee to permit reimbursement for research, a loss on securities taken in exchanges, or other devices, it is clear that those fees may be considered excessive. Underwriting fees are supposed to be paid to compensate for market risk, capital committment and the maintenance of a distribution network. I suggest that you review your practices. If you justify research in part, for example, by giving that department a mental credit for a portion of underwriting income, you may be fooling yourself. This battle will be brief and fierce, but its outcome is not in doubt, even now.

Fourth, and finally, will come the industry's Armageddon. I am here at the invitation of a representative of one of the combatants, and am asked to address the other faction. This battle is the economic one between the commercial banks and the brokerage industry. Each side has advantages and disadvantages. The commercial banks have size, money and economic clout. However, at present they are limited in their marketing area. There is no nation-wide banking. The brokerage community has nationwide distributive capability, unlimited product lines, is adaptable and can be creative. However, it expends most of its political effort fighting internecine wars of attrition, such as the one on a National Market System. To keep their independence, the brokers must develop the political skills of the bankers. To contrast the two styles, just compare an agenda at an ABA annual meeting with a comparable SIA meeting. Need I say more?

Conclusion

I would like to conclude with a positive thought. The securities industry is, in my judgement, at the threshhold of a marvelous new era of opportunity, and profit potential. Leaner, hungrier and smarter than ever before, the survivors of recent hard times can have a lot of fun working hard and being creative. A word of caution, however. Remember the business you are in. That business is providing sound, economic financial services to individuals and institutions, and to engage in the functions of market making and distribution. Do not let the romanticism of the means let it become an end in itself.

The market mechanism is just that, a mechanism. It, like the airplane on which I arrived here today, is a transportation facility. Instead of people, the market facilities transport trading information. The airlines do not make business policy for their travellers, but the securities market mechanisms have been doing so for you.

Time is short. You cannot afford to play Alphonse and Gaston with your business future. If you wish, you can mark this date as the start of the real building of the National Market System. The alternative is for you to note that it is November 10, 1977.

I have enjoyed this opportunity to share my thoughts with you.

Thank you.