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A CONSERVATIVE APPROACH TO RADICAL CHANGE

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Whenever businessmen and lawyers get together, it doesn't take long for someone to turn the discussion to the pervasive problem of government intervention in the private sector. From there, it is usually just a matter of time before someone begins speculating about the proportion of corporate expenses represented by legal fees -- and the number of lawyers who may actually be functioning as chief executive officers of corporations today.

Time was, of course, when most business executives could confidently delegate most of the business of dealing with government to trusted legal counsel and focus their own attention almost exclusively on running the business. No more.

I don't have any statistics on this, but the ever-expanding web of government regulations, restrictions, reporting requirements and what-have-you seem to have made corporate legal practice one of the nation's liveliest and most consistent growth industries.

As you probably are aware, new equity underwritings have slowed to a trickle, compared with public offerings a decade ago, and many people have been looking for a new growth industry that might capture the imagination and interest of public investors. Now, we all know that corporate lawyers' profits do not depend much on whether business elsewhere is good, bad or indifferent; so it occurs to me that we might get the stock market moving again if some of your legal firms would go public and offer investors a chance to invest in the litigation boom.

This could even be a potential growth area for stock exchange listings. We already have a listed company whose stock symbol is LAW. But we might be able to persuade Lawter Chemicals to relinquish it to the first listed law firm.

In any event, the ongoing boom in government regulation, proposals for corporate governance legislation and the like have forced more and more business people to spend more and more hours of expensive executive time trying to understand and cope with the presence and impact of government in and on corporate affairs.

We have reached a point where any executive who ignores the implications of any government policy or action that even indirectly affects the business he is paid to manage is simply setting himself up for some very unpleasant surprises in the future.

It has been said, in fact, that the business of business today is government. And while that may overstate the case, the business of dealing with government has become, at the very least, a mainstream activity of business.

The experience of the securities industry in dealing with government is perhaps well beyond the norm. But, particularly to someone like myself, who came to the industry from a more conventional kind of corporate career, it is certainly very instructive.

A BETTER WAY TO RUN THE BUSINESS

When I first became involved --as a Public Director of the New York Stock Exchange, back in 1972-- one of the major issues before the Board was whether or not there ought to be some kind of centralized system for trading corporate securities. Six years later, as several key members of Congress have pointedly observed, the entire securities industry and its government overseers still have not solved all the complex problems of how to put such a system into operation.

In the interim, hundreds --perhaps thousands-- of hours of public hearings have been held. Tens of thousands of pages of testimony and comment from just about anyone who might have useful ideas on this issue have been duly transcribed, mulled over and analyzed. Proposals and counter-proposals have been set forth, examined, discussed, revised and either discarded or earmarked for further study.

The idea of a nationwide system that could give a stronger public-interest orientation to trading in corporate securities began to emerge in discussions of securities industry issues nearly a decade ago. Perhaps the first major attempt to describe what was initially called a "central market system" appeared early in 1971, when the Securities and Exchange Commission transmitted to Congress a detailed study of the growing impact on the securities markets of the investment activities of such financial intermediaries as banks, mutual funds, pension funds and insurance companies.

At about the same time, the New York Stock Exchange asked former Federal Reserve Board Chairman William McChesney Martin --who had been the Exchange's first paid president, from 1938 to 1941-- to see if there might be a better way to run its business. Mr. Martin conducted a thorough study of the Exchange's constitution, rules and procedures. His "Report With Recommendations" was published in August 1971 and, as some of you may recall, led to a major restructuring of the Exchange. One of his key recommendations called for "development of a national exchange system providing a national auction market for each listed security."

Also during 1971, committees of both houses of Congress, and the SEC, held public hearings at which the central market concept received considerable attention; and all three study groups endorsed the idea of a central market system in their subsequent reports. The SEC's

"Statement On The Future Of The Securities Markets," issued in February 1972, noted that "it is generally agreed that action must be taken to create a single market system for listed securities."

A NATIONAL POLICY OBJECTIVE

About 14 months later, in late March 1973, the Commission issued a major "Policy Statement On The Structure Of A Central Market System." In that statement, the SEC stressed its commitment to "the preservation of an auction-agency market" and to "an efficient and comprehensive communications linkage between market centers, consisting of a real-time composite transaction reporting system and a composite quotation system displaying bids and offers of all qualified market-makers in listed securities."

Later that year, Congress began shaping new Federal securities legislation -- a process that continued through 1974 and culminated in the passage of the Securities Acts Amendments of 1975. Among a great many other very important measures, that legislation identified the development of a National Market System as a national goal, and directed the SEC to facilitate its establishment.

But while the Amendments spelled out what a National Market System should achieve, Congress stopped short of describing such a system or suggesting how it should come into existence.

The legislation specifies, for example, that a National Market System should improve efficiency; it should be competitive; it should protect the interests of investors; and it should help strengthen the effectiveness of capital allocation in this country. Congress also specifically --and significantly-- noted that "the securities markets are an important national asset which must be preserved and strengthened."

To my knowledge, no one has ever quarreled with any of those objectives, and everyone supports them. But in writing them into the law of the land, Congress, in effect, told the securities industry and the SEC to devise an ideal structure for which --notwithstanding at least four years of prior discussion and debate-- not even preliminary blueprints had been designed.

In your profession, an admittedly imperfect analogy might involve ordering the various state bar associations to cooperate in designing and implementing a new court structure that would be consistent with constitutional guarantees of justice for all; that would provide maximum efficiency in clearing crowded court calendars; that would establish completely uniform state trial and appellate procedures; and that would reflect, harmonize and incorporate the best thinking of anyone who is professionally qualified to have an opinion about how the court system should be organized and operate.

Could all the combined skills and genius of the legal profession produce a new or revised court system to meet those objectives within two years? That's a loaded question, of course, and it answers itself.

In our case, the best minds in and around the securities industry have been hard at work trying to design and develop the specifications for a viable National Market System. And, in fact, the Consolidated Tape --one of the earliest elements proposed by the SEC-- became fully operational more than a year and a half ago, just 12 days after President Ford signed the 1975 Securities Acts Amendments into law. Although some legal snags have developed, the technology for a National Clearance and Settlement System also exists, and much of the necessary planning has been completed.

A DIVERSITY OF INTERESTS

And while some of the answers continue to elude us, there has been a good deal more additional progress toward a National Market System than is generally recognized -- or than some critics of the industry seem willing to acknowledge.

The diversity of legitimate interests which must necessarily be affected by both the style and the substance of a National Market System has been at least partly responsible for what some observers persist in viewing as a relatively slow rate of progress.

The 1975 legislation empowered the SEC to create a National Market Advisory Board to help determine the parameters of a National Market System. And that group --which included representatives of the public, the corporate and academic communities and the legal profession, as well as the various elements of the securities industry-- subsequently served as a forum for a wide range of ideas and issues relating to a National Market System.

There was some hope at the outset that the Advisory Board might come up with all the answers -- and considerable disappointment in some quarters when, two years later, it had not. And it is easy to sympathize with NMAB Chairman John Scanlon, who pointed out at the Board's final meeting last month that:

"The statute required that the Board be dominated by industry people and represent various points of view. The Commission did a very good job of picking people representing various interests...In so doing, however, they foreordained that there would not be consensus."

It should not be surprising that the various interests focused on the various types of approaches to a National Market System that best suited them. It was unlikely, for example, that an over-the-counter dealer in exchange-listed stocks would favor a proposal he perceived as disadvantageous to third-market dealers generally -- or, for that matter, that an exchange specialist would be very receptive to ideas for doing away with exchange trading floors.

And of course, as with almost any idea whose time is perceived as having come, increasingly ambitious --and, in some instances, increasingly radical-- proposals began reaching the NMAB. The initial focus of improving and building upon the strengths of the existing system began to blur as suggestions were introduced for tearing down the system and replacing it with something else.

As time went on, government grew increasingly impatient. Although no one had been able to tell the industry what government wanted a National Market System to be, government officials seemed annoyed that the industry had not produced it overnight.

FIRE ALL THE JUDGES

Then, as a glimmer of consensus began to emerge among many of the major securities industry self-regulatory organizations on some of the key issues, the SEC proposed to abolish the so-called off-board trading rules of the various stock exchanges. These rules have the effect of directing most of the trading in listed stocks to the exchanges -- and the SEC declared them to be anticompetitive. Unless the rules could be shown necessary to further the purposes of existing Federal securities laws, the Commission indicated, they would have to come off the books.

Whatever the impact of the off-board trading rules may be on certain types of competition, they are, undeniably, the linchpin of the exchange markets -- and removing them without taking any compensatory action could very well send the markets careening out of control.

The enormity of the possible consequences led some observers to suggest that the SEC's proposal was really aimed at prodding the industry to get its National Market System act together. But going back to the analogy I suggested earlier, that would be rather like telling the legal profession: since you haven't come up with a plan for reorganizing the courts, we are going to fire all the judges.

In any case, the off-board trading rule proposal did succeed in alerting much of Corporate America to its stake --and its stockholders' stake-- in the issue. Proposals that had not previously been perceived as having much relevance outside the securities industry began to be widely recognized as a serious threat to the viability of trading in the stocks of literally hundreds of corporations.

Nearly all the witnesses at hearings held by the SEC last August --25 out of 29, to be precise-- urged against hasty action by the Commission. And subsequently, some 200 chief executive and other senior officers of listed corporations expressed to the SEC --and, in some instances, to their representatives in Congress-- their very serious concerns about how precipitous repeal of the off-board trading rules might adversely affect their companies' stock price movements and capital-raising efforts.

It is pertinent to note, too, that serious concerns about the impact on the securities industry in New York were expressed to the SEC by Osborne Elliott, who was then the city's Deputy Mayor for Economic Development. More recently, the New York Job Development Authority asked the SEC to file an environmental impact statement prior to taking any action that would remove the off-board trading rules. Citing the prospect of significant job losses in New York, the Authority pointed out that Federal law requires filing such statements whenever "major Federal action significantly affecting the quality of the human environment is contemplated."

The Commission was originally expected to announce a decision on the off-board trading rules question before the end of 1977. However, that decision was deferred, and we are now expecting a statement by the end of this month. To date, the Commission has not suggested what action it might ultimately propose or take, but Chairman Harold M. Williams has indicated that they will be addressing the issue in the context of National Market System developments.

ITS: A NATIONAL TRADING SYSTEM

Meanwhile, the industry has by no means been sitting on its hands. Five of the nation's leading marketplaces --the American, Boston, New York, Pacific and Philadelphia Stock Exchanges-- have succeeded in resolving most of their initial conceptual differences about how to expand trading among the markets in which many corporate stocks are dually or multiply listed and traded. We are, at this moment, putting the finishing touches on plans for implementing a new Intermarket Trading System that we believe can serve as a key building block for a National Market System. And the present participants have invited the other major markets --including those supervised by the National Association of Securities Dealers-- to help complete the nationwide trading network that will soon be in place.

The Intermarket Trading System --or ITS, for short-- centers on an electronic linkage that will permit orders in listed stocks in any participating marketplace to interact almost instantaneously with orders in the same stocks in the other markets.

The ITS linkage consists, essentially, of a central computer facility and a network of interconnected terminal devices and printers in the participating market centers. It will operate in conjunction with quotation displays in each market center. These displays will show the current quote for each stock traded in that market, and either the current quotes in all other markets in the system or the best quote available systemwide.

How will all this work?

Let's assume that a broker or market-maker on the New York Stock Exchange trading floor holds a customer's market order to buy 100 shares of a listed stock that is also traded on one or more other exchanges. By scanning a visual quotation display at the NYSE specialist's trading post, he may discover that a better offer currently exists, say, on the Pacific Exchange in Los Angeles. If the NYSE specialist --for whatever reason-- cannot match that offer, the broker may decide immediately to send an electronic message to the Pacific Exchange, committing himself to buy 100 shares for his customer at the price shown on the quotation display. When that commitment is accepted in Los Angeles, the broker in New York will receive a return message --within as few as 30 seconds-- telling him that the transaction has been executed in Los Angeles; that he has, in fact, bought 100 shares for his customer at the price shown on the display at the NYSE specialist's post. This is the equivalent of the traditional brokers' handshake --stretching across the continent-- signifying that a trade has taken place.

PILOT PROGRAM IN APRIL

I should make clear that we are not talking about something that may happen in the distant future. If our current plans go according to schedule, we will inaugurate a pilot operation in a selected group of stocks in April. By the end of summer, we hope to expand the operation to include many of the most competitively traded stocks. We will, of course, be closely monitoring and evaluating each phase of the operation --and improving or modifying it, as necessary-- before moving on to the next.

We believe this is a realistic approach to assuring that there will continue to be a strong national trading environment for listed stocks, and to preparing the way for a smooth transition to whatever may come next in the evolution of a National Market System.

I think it must be obvious to almost everyone that while we are about to take a very important step forward, this is not a revolutionary approach to a National Market System. It will not create a mysterious or intimidating "black box" system where all trading might be poured into a single computer mold. On the contrary, ITS will use computer technology to support the exercise of human judgment in determining how a broad range of trading strategies can best be used to serve the individual needs and wishes of investors.

Our objective is to build creatively on the existing market structure. We want to improve what we have --in ways that, together with other initiatives from the private sector and government, can give new impetus to public participation in the basic processes of private enterprise capitalism in America. We want to evolve a securities trading system that will support and enhance our national economic strength.

AN EVOLUTIONARY APPROACH

I do not pretend to be an expert interpreter of Congressional intent. But it does seem likely that this kind of gradual approach to a better securities trading system is what most members of Congress had in mind when they voted to make the establishment of a National Market System a prime goal of national economic policy.

To be sure, there have been a few adverse comments about the industry not taking drastic enough steps to change the present system. A few people have suggested that perhaps government should design and build a National Market System -- that government might, in effect, take over the operation of the markets and the allocation of private capital in this country. That, of course, would be tantamount not to a National Market System, but to a nationalized market system. And I doubt that many Americans, in or out of Congress, would choose to impose that kind of brake on our system of private enterprise capitalism.

More encouragingly, it does now begin to seem that most of the interested parties are willing to take a more prudent course -- and to give the Intermarket Trading System a fair opportunity to demonstrate its effectiveness. At the New York Stock Exchange, we are confident that

ITS offers specific benefits to investors and listed corporations that will fully justify this approach. And I believe the other participating marketplaces share our confidence.

ITS will give all investors the opportunity to obtain the best price available within the system -- for any stock at any time.

It will preserve and strengthen the integrity of the market mechanism and permit continuity of effective surveillance and regulation.

It offers the prospect of greater liquidity and better price continuity within the system -- and the cost benefits that can result from narrower price spreads.

We believe, too, that corporate issuers will readily recognize how these benefits to investors can redound to the benefit of listed corporations. Trading in listed stocks will reflect, continuously, the range of supply and demand in the system at any given moment. ITS will help assure that buy and sell orders can flow, unimpeded, to the marketplace offering the most advantageous prices. The resulting interaction of orders will strengthen the trading mechanism, and we believe a better trading system will stimulate increased public interest and investment in corporate equities. And to the extent that ITS can lower the costs and improve the quality of trading in the secondary markets, it should strengthen the ability of listed companies to raise new equity capital for growth and expansion.

Moreover, successful implementation of ITS will almost certainly spur the development of future enhancements and applications of competitive, long-distance trading. And that may very well add up to a functioning National Market System long before more grandiose --and far more expensive-- concepts could be blueprinted, tested and put into operation.

In short, we have opted for an evolutionary approach to change -- a conservative approach, if you will, but certainly a prudent approach.

Stated somewhat differently, we have tried to persuade government not to try to push the securities industry into a costly, dangerous error that could cause irreparable damage to the nation's capital markets.

In the weeks ahead, we will be bringing the Intermarket Trading System into the initial operating phase. How radical will the changes really prove to be? Truthfully, we cannot be certain. But we will be watching its impact on trading in listed stocks very closely. As we gain practical experience with ITS, we will almost certainly begin developing additional refinements and changes aimed at permitting a true National Market System to evolve -- logically, effectively and, most important, in the service of corporate issuers and the investing public.

We certainly expect to receive suggestions from government. Equally important, we earnestly hope the corporations whose stocks are traded in the new environment will cooperate with us and with government to --as Congress so aptly put it-- improve and strengthen the important national asset that is the U.S. securities markets.

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