NATIONAL MARKET SYSTEM DEVELOPMENTS: CHANGE AT THE EXCHANGE

REMARKS BY WILLIAM M. BATTEN
CHAIRMAN, NEW YORK STOCK EXCHANGE, INC.
AT THE 12TH ANNUAL INVESTMENT WORKSHOP
SPONSORED BY THE FINANCIAL ANALYSTS FEDERATION
AT THE AMOS TUCK SCHOOL OF BUSINESS ADMINISTRATION
DARTMOUTH COLLEGE
HANOVER, N.H.

July 26, 1979

Back in January, we conducted a rather unusual seminar at the New York Stock Exchange. It was unusual in that our guests were all well-known professors of business and finance. And among them was Dean Richard West, who is your host here at Dartmouth. So my visit here has at least an element of quid pro quo.

We held that seminar because we wanted an honest dialogue with the leading academicians in the securities field, at least some of whom have been among the Exchange's staunchest critics in the past. We wanted to let them know what we've been up to recently. And we hoped to get their ideas about what we were doing wrong and what, if anything, they thought we were doing right.

We learned that, contrary to popular wisdom in our industry, they aren't stubbornly antagonistic to our market system. And several of them acknowledged that they had some outdated ideas about us. One of them said, "I guess I have to make a lot of changes in what I've been teaching." And another went even further. "I've got to go back and junk my whole course," he said – "it's just not relevant to what's happening today."

What is happening today at the Exchange? A complete rundown would probably keep us here past midnight. So I'd like to focus on just a few of the things that underscore the last six letters of our name -- a word that people don't often associate with us: Change.

BROADENING THE PRODUCT LINE

To me --as a long-time merchandising and marketing man-- one of the most exciting things we're doing is broadening our product line beyond the conventional range of corporate securities that have been the mainstays of the Exchange market for nearly two centuries.

- First, we are pushing ahead to enter an entirely new field, with the establishment of the New York Futures Exchange -- a wholly owned subsidiary of the New York Stock Exchange. Pending approval by the Commodities Futures Trading Commission, we expect to begin operating early next year as a contract market for 90-day U.S. Treasury Bills, 20-year U.S. Treasury Bonds, and five foreign currencies: British Pounds, Canadian Dollars, West German Marks, Japanese Yen and Swiss Francs. And we are prepared to expand trading capacity rapidly over the next three years.

We're excited about the futures business because we think we can provide something investors want: an attractive new place to shop; an additional opportunity for hedging investment risks; and the ability to upgrade the quality of regulation and surveillance in a field where some investors seem to believe improvement is overdue.

- We have also introduced enhancements to our Automated Bond System that are greatly expanding the Exchange's potential for becoming a much more aggressive competitor for the flow of orders in listed corporate bonds. This is an area of product development which, unaccountably, the Exchange has overlooked for far too long.

- And, as you know, subject to the SEC's long-awaited decisions about permitting expanded trading in standardized options, we are eager to get on with the creation of a New York Stock Exchange Options Market. This is another area in which we think our operational and regulatory experience can add new dimensions of stability and service from which the investing public will benefit.

THE MODERN MARKETPLACE

As we continue to expand the range of products available in our marketplace, we are focusing ever more intently on the importance of the Exchange's ability to keep pace with -- indeed, ahead of-- the intensely competitive trading environment of the future. And since corporate stocks will almost certainly continue to be our leading product, we are making some dramatic physical changes in our main trading areas. The accelerating pace of competition for the flow of investors' orders to buy and sell listed stocks demands that we be able to accommodate the complex new electronic systems that are proliferating in connection with the evolving National Market System. And we must also be prepared for whatever the future may hold.

So we are replacing all the old trading posts --most of which have been in place for half a century-- with a new modular-design posts that can be readily modified, rearranged and restructured to accept whatever new electronic systems may be taking shape a decade or more down the road.

One of the new posts is already operating on a pilot basis, and we expect to complete the conversion --without any interruption in the trading of any listed stock-- by the fall of next year.

THE EVOLVING NATIONAL MARKET SYSTEM

All of these changes --and I can assure you that there are many more, either in progress or on the drawing boards-- are related in one way or another to the ongoing evolution of a National Market System for securities.

There has been a fair amount of misunderstanding about what a National Market System is supposed to be -- and some confusion about how close we are to having one. So I'd like to take a few minutes to try to clear up a few points.

Although Congress set the ground rules for developing a National Market System, the legislators were too wise to expect the system to spring, full-grown, from the Securities Acts Amendments of 1975. What Congress did was to specify what the system should accomplish -- what objectives the industry and the SEC should be trying to reach.

Congress made clear, for example, that the legislative goal was to preserve and strengthen the securities markets, which it described as "an important national asset."

Congress also indicated that a major objective of a National Market System should be to enable all buying and selling interests in qualified securities to meet and interact within the system.

A third essential Congressional specification was that the various competing markets should be linked through new data-processing and communications capabilities. Implicit in this was the belief that an effective nationwide market linkage would produce a number of specific benefits:

- It would foster efficient execution of investors' orders.
- It would broaden and intensify competition among the various market participants.

- It would increase the scope and quality of market information available to investors and market professionals alike.

- It would assure brokers an opportunity to execute customers' orders in the best market.

- And it would enhance the possibility of executing investors' orders without the intervention of a dealer.

Other goals inherent in the Congressional guidelines make it clear that a National Market System must provide for effective surveillance of market activity; that it must include, as an integral element, the means for assuring price protection for customers' limit orders; and that it should preclude market professionals from dealing with customers to the customers' disadvantage.

The SEC and most segments of the securities industry have agreed on most of the basic characteristics of the system. And this has helped generate a cooperative spirit that has brought us a long way toward meeting the Congressional goals. An accelerating evolutionary movement has brought into operation such key elements as the consolidated tape, the composite quote system, and a national clearance and settlement system.

Perhaps the most significant accomplishment to date has been the implementation and ongoing expansion of the Intermarket Trading System that now electronically links trading in more than half the 1,000 or so eligible listed stocks that are competitively traded on any two or more of the six participating exchanges. By enabling any broker holding a customer's order on the floor of any exchange to reach out for the best price currently available on any of those exchanges, ITS has effectively eliminated geography as a factor in how and where listed stocks are traded.

Expansion and enhancement of ITS have brought us to the point where, last month, a daily average of more than 780,000 shares traded through it, with more than 77% of all trading commitments actually being executed on another exchange. It now takes an average of only 44 seconds for a broker on one floor to make a commitment to buy or sell a specified number of shares of an ITS stock offered or bid for on another exchange -- and to receive a response telling him that the order has been executed there.

With the essential trading linkage now well on the way to full implementation, we are directing more and more of our attention to ways of providing full systemwide protection for public limit orders – another key National Market System goal.

Specifically, we are moving ahead with development of our Market Center Limit Order File, which has come to be known by the somewhat Hibernian acronym, MCLOF. As you may be aware, MCLOF is an electronic facility that, in conjunction with ITS, will be able to display limit orders held by brokers in the trading crowd, or on the specialist's book, for protection in our market against inferior price executions elsewhere.

MCLOF's electronic order and report-transmission capability will enable participating firms to handle customers' orders more efficiently and economically. Ultimately, they will be able to find out, by electronic inquiry, the status of any order they have entered into the system. And we believe that MCLOF can become the foundation for a comprehensive Intermarket Limit Order Protection System that, with ITS, will meet the Congressional objective of maximizing protection of public limit orders displayed throughout the National Market System.

CONSTITUENT DEMOCRACY IN ACTION

Obviously, the major changes I've been describing have required some pretty tough decision-making. And if you think that Mil Batten sits in his office at 11 Wall Street grinding out solutions to the complex and often controversial issues facing the Exchange, you're dead wrong. So I'd like to say something about how we go about managing change these days.

It has become increasingly clear to all of us at the Exchange that securities marketplaces are quasi-public institutions. The decisions made by our Board of Directors directly or indirectly affect the legitimate interests of many groups, both within and outside the securities industry. And we believe they are entitled --that they have a responsibility-- to help shape the policies that determine the quality and effectiveness of our marketplace.

Those beliefs began emerging in the aftermath of the industry's operational and financial crises a decade ago. The first decisive step at the Exchange was to restructure the governing board -- from a cumbersome 33-member body that included only 3 public members, to a corporate-style Board of Directors consisting of 10 securities industry members, 10 public members, and a full-time paid chairman.

Since then, we have also developed a carefully structured Board Committee system that draws equally on the skills and expertise of Public and Industry Directors. And we have expanded outside participation in decision-making by chartering high-level Advisory Committees of specific constituent groups to assist the Board in reaching decisions that reflect their policy-related interests, concerns and expertise.

Today, seven such committees regularly provide the Board with extremely valuable input. Three of them represent different elements within the Exchange membership: small firms, regional firms and upstairs traders. Four others keep the Board posted on matters involving the international capital markets; the needs and views of institutional investors; securities-related issues of particular interest to the legal profession; and the concerns of listed companies.

Our approach to the SEC's recent proposal to abridge the off-board trading rules of the various exchanges offers virtually a case study of how these committees get involved in constituent-oriented decision-making.

REVISITING AN OLD ISSUE

The off-board trading rules, as you know, are the rules which generally require stock exchange member firms to buy and sell listed stocks, as brokers or dealers, on an exchange.

You may recall that, back in 1977, the SEC proposed outright repeal of the existing rules. That proposal ran into a storm of opposition from the exchanges and, after we explained the predictable consequences, from members of Congress; from the great majority of securities firms; from listed companies, which stood to lose the high-quality markets that attract investors; and from representatives of many institutional and individual investors, who spoke out against the grave threat to their interests that was inherent in a plan that could seriously damage the basic stock exchange pricing mechanism.

Then, last April, the Commission proposed an experiment that, it claimed, "would…not appear to involve the potential for the kind of dramatic and radical effects…predicted" in 1977.

This new proposal would exempt from the existing off-board trading rules--and particularly NYSE Rule 390-- the stocks of any listed company that were traded exclusively over the counter before last April 26th. In other words, it would permit unrestricted over-the-counter trading in any such stock after it became listed. Any broker-dealer --including NYSE members and member firms-- would be free to trade in any such stock, as principal, against his customers' orders, at his own prices, in his own offices, without attempting to obtain a better execution anywhere else.

The proposal was described as a limited experiment that would affect only a relative handful of stocks. And the initial reaction, in many quarters, was that it was not unreasonable. Some went so far as to suggest that even the exchanges couldn't, in good conscience, oppose it. But as our staff began analyzing the proposal, some very disquieting ramifications --for us and for our constituents-- started coming to light.

We began asking some basic questions. Was the proposal consistent with National Market System objectives? How would it affect continuing progress toward those goals? Would it improve real competition among orders in the stocks involved -- or would it merely increase the number of competitors? What would be the impact on public investors' confidence in the listed markets?

Within a scant two months, we had to answer these and scores of other questions and be prepared to testify at hearings to be held in June. Most important, we needed both to inform and get the views of our constituents.

A RACE AGAINST TIME

Key staff members presented the issues to our Board, to each of the Advisory Committees and to other knowledgeable individuals within and outside the industry -- and asked them to feed their ideas back to the staff task force that was beginning to hammer out our basic position. Several key points began to emerge.

First, the SEC's proposal seemed completely at odds with the Congressional goals for a National Market System.

Second, there were great gaps between the terms of the proposal and universally accepted principles of investor protection. And this could damage investor confidence in listed markets.

Regional and small firms expressed alarm at how competitive opportunities would be skewed in favor of large well-capitalized firms.

Institutional traders expressed concern about the inability of public orders to interact with --or improve upon the prices of-- in-house trades in the stocks that would be exempt from the off-board trading rules. The also raised the question of NYSE Rule 113 which, among other things, prohibits Exchange specialists from accepting orders directly from institutional investors or corporate issuers. Should that rule be lifted, or should it be extended to all other market-makers in the exempt stocks? Neither alternative seemed satisfactory; but without one or the other, there would be a clear competitive imbalance in favor of upstairs market-makers.

Delays in reporting transactions from scattered dealer offices would play havoc with the tape. For example, Dealer A, in Seattle, might trade XYZ stock at 19; Dealer B, in Dallas, might trade it at 20; and Dealer C, in Boston, or Dealer A's Boston office, might trade it at 20-1/2 -- in that order. But those trades might very well be reported out of sequence on the tape, so that the last sale would appear to have been at 19 --instead of at 20-1/2-- and the market in XYZ would seem to be falling instead of rising.

As the various Advisory Committees examined the SEC's proposal from their own unique perspectives, they found themselves resolving differing views into committee consensuses acceptable to their respective members. Two groups --the Institutional Traders and Small Firms Advisory Committees-- decided to oppose the proposal and submitted their views to the SEC in writing, even before the Exchange's detailed presentation was finalized.

In addition, half a dozen members or former members of those committees, and of the Upstairs Traders Advisory Committee, decided that they felt strongly enough about the issues to go down to Washington themselves and testify --as concerned individuals-- at the hearings in late June. And members of our Listed Company Advisory Committee, and other listed company executives, have added their views to the record by submitting post-hearing comments to the Commission.

The bottom line here, I believe, is that our constituent liaison system provided a framework for crystallizing our constituents' views and bringing their specific concerns to the attention of the SEC -- in a manner that the Exchange alone could not have done. And while their views, in some instances, were not identical with ours, I think it is entirely fair to say that the Exchange's final, formal position does represent a consensus among all our constituents who have a recognized stake in the Commission's ultimate decision.

THE EXCHANGE'S POSITION

And so I might just summarize briefly, where we did come out. Our statement stressed three major points:

First, we reaffirmed that the industry's --and the SEC's-- highest priority should be to achieve the objectives of a National Market System, including systemwide protection of public limit orders.

Second, we detailed our belief that experimenting with the off-board trading rules at this time would impede progress toward those goals and adversely affect investor confidence in the listed markets.

And third, we decided to introduce the concept for an alternative proposal that we think may make it easier for the SEC to honor the concerns of the vast majority of those who opposed the proposed experiment.

Recognizing that the Commission feels compelled to do something to enhance market-making competition in listed stocks, we called for a cooperative effort to develop an efficient, cost-effective way to enable off-floor market-makers who want to commit risk capital to compete in making continuous two-sided markets in listed stocks -- within the framework of the emerging National Market System. We pledged our best efforts to design a specific proposal by the end of this year. And we will, of course, be seeking the advice and counsel of all our constituents in drawing up that blueprint.

CONCLUDING REMARKS

Regardless of how the Exchange may have viewed its constituent relationships in the past, it is central to our management philosophy today that our decisions must reflect the needs and views of all who are affected by them.

This means much more than merely being alert to our constituents' concerns. It means seeking out their views and encouraging them to become directly and intimately involved in the full range of our decision-making. We are, in short, determined --in approaching any issue-- to obtain the best thinking of everyone who may have something to contribute. The responses have been gratifying. They have been constructive. And they will be increasingly essential.

We think this is the best way to manage the vast and dramatic changes that are sweeping over the securities industry today.

We are convinced that it is the only logical approach to shaping decisions that will preserve and strengthen the securities markets and merit public support and confidence.

And we know it is an important key to achieving the New York Stock Exchange's basic management objective. And that is: To be the most competitive, modern, cost-effective, responsibly diversified marketplace, and to maximize our contribution to assuring the continuing existence of strong capital markets in this country.

# # # # # # # #