

# NEWS

## SECURITIES AND EXCHANGE COMMISSION

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THE FUTURE IS FOR THOSE WHO ARE PREPARED

ADDRESS BY

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I appreciate the opportunity to share some of my views about our securities markets with you this evening. Since everyone here knows that our securities markets are the best in the world, I am sure I was not invited here to tell you that. All of you are also aware that the over-the-counter securities market, provides capital for thousands of large and small corporations and investment opportunities for millions of investors, and that its growth and continued vitality depends heavily on the ability of members of this association to underwrite and trade securities in a manner which is efficient, fair, and profitable.

I believe the basic purpose of this 48th Annual Convention is to discuss industry changes and problems, and consider ways of improving your ability as an industry and as individual firms to meet the needs of investors and public corporations in the future. The past and present, of course, provide insights that can be helpful in this endeavor.

The past decade has been a period of significant change in our securities markets. Advances in computer and communications technology have permitted the development of systems for the dissemination of real-time market information, inter-market linkages and fully automated trading systems. Although the focus of change during the past several years has been primarily on the market for listed securities, dramatic changes have also taken place in the over-the-counter market. In fact, the development of NASDAQ, which began operations just ten years ago, has transformed the over-the-counter market. Many OTC firms have prospered in the changed environment, but those that were not willing or able to adjust to new conditions are gone.

The advances in technology that made NASDAQ possible have also made it possible to have world-wide securities markets, and innovative, sophisticated financial services such as money market funds, cash management accounts, repurchase agreements, variable annuities, and dividend reinvestment programs. These new services generally offer greater convenience and financial benefits to customers and often are structured to permit dissimilar institutions to compete with each other notwithstanding anti-competitive legislative and regulatory barriers. A major extension of government regulation would be required to shore up the crumbling regulatory boundaries between various types of financial and commercial institutions. In my view, both economic theory and empirical evidence lead to the conclusion that such increased regulation would stifle initiative and innovation, and would not be in the public interest.

I expect the period ahead to hold even more challenges and opportunities as outmoded barriers to competition within the securities industry and between various financial

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The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

institutions fall, and believe that it is a crucial responsibility of Congress, the Commission, and private industry to focus on these trends so that needed changes in laws, regulations, and facilities may be rationally implemented.

As many of you know, for more than seven years I have been urging Congress to review what appear to be increasingly ineffective anti-competitive legal distinctions between financial institutions and for a similar period, have been one of the strongest proponents of permitting greater competition within the securities industry through a national market system.

I strongly disagree with recent suggestions that, because of changes in the securities markets and the regulatory environment, the development of a national market system should no longer be a priority item for the securities industry and the Commission. Achievement of the basic objectives set forth over six years ago in amendments to the Exchange Act--to assure competitive securities markets, the availability of accurate and timely quotation and transaction reports, the efficient execution of transactions, and maximum opportunities for best execution of public orders--is essential if our nation's capital markets are to continue to be the best in the world. Expected increases in volume make the early achievement of these objectives even more important. Moreover, in my opinion, the national market system program envisioned by Congress in 1975, with its emphasis on removing anti-competitive regulatory restrictions and encouraging cooperation among self-regulatory organizations, is in harmony with the deregulatory spirit which the American public has demanded that its Government embrace.

In this connection, it has always been clear to me that Congress did not intend the Commission's role in the development of a national market system to be that of system's analyst or designer of facilities. Congress expected that the system would "evolve through the interplay of competitive forces as unnecessary regulatory restrictions [were] removed." The Commission's role in this process was to be that of a facilitator, by eliminating inappropriate barriers to competition and using the powers granted by Congress "to act promptly and effectively to insure that the essential mechanisms" were "put into place as rapidly as possible." The securities industry was expected to assume primary responsibility for the design and development of the technical components of the system. In my opinion, the Commission's reluctance to remove fully barriers to competition between exchanges and the over-the-counter market, has necessitated our being more involved in ordering specific mechanisms than would otherwise have been the case.

Progress is being made toward a national market system. A consolidated transaction reporting mechanism, providing last sale information with respect to listed securities, has been operational for five years. A consolidated quotation

system, though still in need of certain enhancements, has also been operational for over three years and quotation information for reported securities is now an integral part of the nation's securities markets. In addition, exchange markets are connected through the Intermarket Trading System ("ITS") and "trade-through" rules have been adopted which provide the first step toward achievement of nationwide price protection for all exchange traded orders. While these developments indicate progress toward achieving the objectives of nationwide information disclosure and price protection for securities listed on exchanges, progress toward increasing competition in marketmaking has been frustratingly slow.

In 1980, the New York Stock Exchange accounted for over 85 percent of trading volume for securities listed on that exchange, demonstrating clearly that, in the present trading environment, the regional exchanges and the third market are able to compete with the NYSE for order flow on an extremely limited basis. Because the ITS does not provide for either automatic execution or time priority, NYSE specialists continue to be able to assure retention of the public order flow which is routed to them by simply matching the quotation displayed by any regional specialist. Thus, as I have previously stated, it is my belief that the development of a national market system could be achieved best, and market making competition may be achievable only, through the responsible removal of regulatory burdens limiting the participation of over-the-counter market makers in exchange-traded securities.

Now let's turn to the developments in the OTC market. Since the start-up of the NASDAQ system in February 1971, the over-the-counter market for NASDAQ securities has become the fastest growing and second largest securities market in the country. Aggregate trading volume in NASDAQ securities has grown from 1.2 billion shares in 1974 to 6.7 billion shares in 1980. Last year NASDAQ share volume rose to 60 percent of New York Stock Exchange volume, compared to 45 percent a year earlier, and exceeded the volume of all other U. S. exchanges combined.

As the volume of over-the-counter trading in NASDAQ securities has grown, the characteristics of that market have also changed. In the past, companies listed on NASDAQ tended to be small, less well-known firms, which received only limited coverage from the financial press. Such companies were often first-time issuers, dependent upon the merchandizing support, or "sponsorship," provided by market makers in their securities. While NASDAQ continues to provide a quotation mechanism for the new issue market, it also provides a market for a substantial number of seasoned companies which, in terms of trading volume, size, and other factors, are comparable to most of the issues listed on the New York and other exchanges. The visibility of the NASDAQ market has also improved dramatically. The National List, consisting of the 1,400 top-ranking NASDAQ Securities,

is now published in most major newspapers throughout the country, and is covered by T.V. and radio as well. The NASDAQ market may be said to have come of age, ranking now as a full fledged alternative to exchange markets.

In order to further enhance the quality of the NASDAQ market, several initiatives have been undertaken recently. In July 1980, the NASD replaced the representative bid and asked quotations ("RBA") in its Level 1 NASDAQ service with the highest bids and lowest offers or "inside quotations". The RBA, which reflected a median of the quotations of all NASDAQ market makers in a security, had been criticized by the Commission and others as being misleading and giving rise to opportunities for over-reaching of customers by broker-dealers. In addition to providing investors with more accurate information, the introduction of inside quotations has narrowed the published spreads on 85 percent of NASDAQ securities. I believe this is a significant achievement.

The NASD has also proposed a modification of the system to permit market makers to display quotation size along with their bids and offers on NASDAQ Level 2 and 3 terminals. This proposal was approved by the Commission last June, and it is expected that the display of quotation size will be implemented in the spring of 1982, after all of the new terminals are in place.

The addition of size will benefit users of the NASDAQ system by giving them more information with which to assess the depth of the market for a particular security. Moreover, competition among NASDAQ market makers will be enhanced and transactions will be executed more efficiently since subscribers of the system will be able to determine the price at which a large order can be executed prior to communicating with other market makers.

Another step taken by the NASD was the adoption of higher qualification standards for NASDAQ securities. In August of 1981, the Commission approved amendments to the NASD's rules which will raise the requirements for inclusion of new issues in the NASDAQ system from \$1 million in total assets and \$500,000 in total capital and surplus to \$2 million in total assets and \$1 million in total capital and surplus. In addition, the NASD's rule amendments will raise the maintenance requirements for securities already in the system from \$500,000 in total assets and \$250,000 in total capital and surplus to \$750,000 in total assets and \$375,000 in total capital and surplus. These changes and others enhance OTC markets considerably, but, as with exchange market improvements, they do not significantly facilitate the Congressionally determined goal of direct competition "between exchange markets and markets other than exchange markets" in "all securities qualified for trading in the national market system."

Some steps are being taken, however, to link or integrate efficiently all markets for qualified securities and enhance opportunities for market maker competition. These include the development of the Cincinnati Stock Exchange's automated National Securities Trading System ("NSTS") and the NASD's Computer Assisted Execution System ("CAES"), the Commission's adoption of Exchange Act Rule 19c-3 which prohibits exchange off-board trading restrictions for securities listed on an exchange after April 26, 1979, and the ordering of an automated interface between CAES and ITS. In adopting Rule 19c-3, the Commission determined that providing increased opportunities for competition between over-the-counter and exchange markets and permitting the securities industry and the Commission to experience and evaluate the effects of concurrent OTC and exchange trading outweighed any potential adverse effects which might occur from "internalization," "fragmentation," or any increased opportunity for "overreaching" of customers. Nevertheless, the Commission instructed its staff to carefully monitor trading in Rule 19c-3 securities and made clear its expectation that the NASD would conduct a rigorous monitoring and enforcement effort in connection with OTC market making in Rule 19c-3 securities.

The Commission recently released its first monitoring report on the operation and effects of Rule 19c-3. Unfortunately, no final conclusions can be drawn because of the limited OTC trading to date, the fact that most of the trading analyzed occurred prior to the commencement of the NASD's CAES pilot, and the absence of an efficient linkage between the OTC and exchange markets. It is important to note, however, that the evidence thus far does not support the fears of those who opposed adoption of the rule. Both the Commission's statistical analysis and interviews with market participants indicated that the removal of off-board trading restrictions, to date, has not had an adverse effect on the market quality of the primary exchange markets.

Moreover, OTC market makers have not chosen to concentrate on only the most actively traded securities, leaving exchange specialists with sole responsibility for providing liquid markets in the less active Rule 19c-3 stocks, as some predicted. Rather, they have apparently focused primarily on moderately active stocks in which they had a strong sponsor relationship before the stock became listed. With respect to execution quality, the report indicates that over-the-counter transactions in Rule 19c-3 stocks have been executed inside the primary exchange quotations with relatively greater frequency than have exchange trades.

The monitoring report also highlights several troublesome facts. Perhaps the most basic finding is that participation by OTC market makers has been so limited that significant competition has developed in only a very few securities. Without greater participation, it is difficult to

fully evaluate the pros and cons of concurrent OTC and exchange trading. Another important finding was that, in the absence of a linkage facility, exchange markets traded through OTC quotations and OTC market makers traded through exchange quotations in a disturbing number of instances.

In my view, the most vital need at this time is an automated interface between the CAES and the ITS systems. Earlier this year, after encouraging the industry to reach agreement on such a linkage voluntarily for over two years, the Commission finally issued an order requiring the development of the Automated Interface by March 1982. In issuing the Order, the Commission found that the prompt implementation of the Automated Interface is a crucial event in the development of a national market system which will address market fragmentation, reduce pricing inefficiencies, enhance the ability of brokerage firms to obtain best execution of customers' orders and promote the type of competitive market structure that a national market system was intended to achieve.

Although the implementation of the Automated Interface is a crucial event, it will not, by itself, ensure the desired trading environment. The national market system was intended to provide an efficient mechanism for all orders to interact with each other and for market makers, whether located on an exchange or not, to compete for order flow, in qualified securities.

Exchange market makers quite naturally do not favor others making markets in their specialty stocks without giving them an opportunity to execute the orders. They have fought vigorously for a rule that would prohibit "internalization" by OTC market makers, even if such market makers made sure that the price received by their customers was as good as the best price being quoted in the consolidated quotation system. On the other hand, exchange market makers apparently do not see any problem in not exposing their orders to interests external to their market and certainly do not believe that in the absence of such exposure, they should be required to improve on the best quote shown in the quote system by others. In fact, "quote matching" is a normal "accepted" fact of life in exchange markets and two exchanges operate automated systems which execute small orders based on a derivative pricing formula without providing meaningful exposure to interests, other than the specialist, in their own market. This procedure, raises significant concerns, particularly if primary exchanges emulate these systems in the future and virtually all orders of 500 shares or less are removed from the trading process. Everyone recognizes that there is a need for efficient processing of small orders, especially during high volume periods, but, the regional and primary exchanges should consider ways in which small orders may be efficiently processed while still being exposed to other trading interest.

The point is, exchange markets also internalize their order flow and some exchanges have less order flow and thus less order exposure in some listed securities than do some OTC market makers. Under these conditions, I find it very difficult to understand how anyone could reasonably expect more from OTC market makers, by way of order exposure to external interests, than is required of exchange market makers.

In order to begin the process of bringing OTC securities into the national market system, on February 17 of this year, the Commission adopted a rule (Exchange Act Rule 11Aa2-1), which establishes procedures by which certain securities traded exclusively in the over-the-counter market will be designated as national market system securities. Among other things, the rule requires that transactions for designated securities be reported in a real-time system and that quotations for such securities be firm as to price and size.

In July 1978, when the Commission first requested comments on the subject of which OTC securities should be designated as qualified for trading in the National Market System, representatives of the over-the-counter market, including the NSTA and NASD, opposed the implementation of a last sale reporting requirement for over-the-counter securities. Concern was expressed that such a requirement would increase the clerical costs of market making in over-the-counter securities and that over-the-counter market makers might be unable to liquidate significant positions effectively if their competitors were aware of the size of that position, through transaction reporting.

After extensive consultation with a broad range of over-the-counter issuers, however, the NASD now supports the Commission's efforts to facilitate last sale reporting for over-the-counter securities. In fact, in a desire to enhance the competitive position of the over-the-counter market, the NASD recently petitioned the Commission to amend the Rule to expand the number of over-the-counter securities eligible for issuer designation as Tier II National Market System Securities from about 500 to approximately 1,450. In that petition, the NASD indicated its belief that such a designation and the accompanying dissemination of last sale information will have a positive, long lasting impact on the over-the-counter market and will be highly beneficial to many NASDAQ companies. Earlier this month the Commission published the NASD's petition for public comment.

I believe last sale information can be beneficial to the market place by enhancing pricing efficiency and increasing the ability of investors to be apprised of efforts to achieve best execution of their orders. Last sale information can also assist the Commission and the NASD to fulfill their oversight responsibilities. At the same time, I recognize the legitimacy



of concerns expressed by the NASD and the NSTA regarding the possible impact of last sale reporting on liquidity in the over-the-counter market. No one knows for sure what effect last sale reporting will have on OTC market making. That is why the Commission has provided that only the most active Tier I OTC securities will initially be subject to such reporting. This will make it possible for issuers, market makers and the Commission to gain some practical experience on which to make evaluations. It may be that last sale reporting will encourage public investment and increase the liquidity of the over-the-counter market. I urge all of you to consider the possible benefits of last sale reporting in your assessment of the NASD's proposal.

Having expressed my views on some issues that I know are of immediate concern to you, I would like to share a long range perspective for your consideration. I referred earlier to the Exchange Act finding that it is in the public interest to assure "competition among brokers and dealers, among exchange markets, and between exchange market and markets other than exchange markets." It is clear from the Act and the legislative history that Congress intended that within the national market system there would be exchange and OTC market maker competition in listed securities through removal of barriers to off-board trading and in certain designated OTC securities through unlisted trading privileges.

I cannot predict when such a trading environment will exist. As I mentioned earlier, however, there are two developing systems which have the purpose of providing efficient mechanisms through which over-the-counter market makers may compete with exchange specialists in listed securities. They are the NASD's Computer Assisted Execution System and the Cincinnati Stock Exchange's National Securities Trading System. I urge both the NASD and the Cincinnati Stock Exchange to consider enhancements to their automated trading systems which would facilitate the ability of firms to efficiently route public orders to those systems. Specifically, NSTS should be enhanced to accommodate unpriced market orders, so that firms may automatically route public orders to NSTS rather than being required to manually price each order. Similarly, the present automated order routing capability of CAES should be enhanced so that when an exchange market is displaying a superior quotation, the order can be routed through the automated interface to that exchange market. When these capabilities are in place, I would encourage firms to participate as market makers in one, or both, of these systems and to consider routing public orders to NSTS or CAES so that they may receive the greatest possible exposure to other trading interests.

Although the NASD's automated execution system is being developed to permit OTC market maker competition with exchanges, it has significantly greater potential. The order routing and execution capabilities of CAES could be highly beneficial also

for over-the-counter market makers and investors in OTC securities. In the present over-the-counter system, which relies on telephone communications, there are problems such as an inability to respond to all inquiries during periods of active trading and delays between the time an order is executed telephonically and when it is reported. CAES could be adapted to provide for automatic executions based on displayed quotations and for automated transaction reporting for OTC securities designated as national market system securities. Such execution procedures would provide broker-dealers greater assurance that orders routed to the best displayed quotation would be executed efficiently and that errors normally encountered in the manual comparison and clearance of transactions would be virtually eliminated. Moreover, the ability of broker-dealers to fulfill their responsibility to provide investors in OTC securities with best execution would be greatly enhanced. Telephonic networks may remain necessary to execute large orders, but the ability to access quotations for designated over-the-counter securities in CAES could provide significant improvements in the handling of smaller orders.

In view of the benefits which may be expected, I urge you to explore with the NASD the possibility of including some exclusively over-the-counter securities in the CAES system, at least on a pilot basis, in the near future. In addition, it is my hope that, as the national market system develops, you will find that it is in your interest and in the interest of your customers to trade the securities of all substantial, actively traded over-the-counter companies in CAES or a CAES-type system. Let us never forget that the future belongs to those who are prepared for it.