SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
(202) 755-4846

ADVANCE FOR USE AT 9:00 P.M. EST, THURSDAY, MARCH 15, 1973

THE CENTRAL MARKET SYSTEM:

PUTTING THE MARKETS TO WORK FOR THE INVESTOR

An Address By

G. Bradford Cook, Chairman

Securities and Exchange Commission

March 15, 1973

NEW YORK FINANCIAL
WRITERS' ASSOCIATION
Americana Hotel
New York, New York

Advance For Use At 9 P.M., EST,
Thursday, March 15, 1973

It is with a great deal of pleasure that I address this annual invitation dinner of the New York Financial Writers' Association. My predecessor as Chairman of the Securities and Exchange Commission, Bill Casey, addressed the financial writers about two months after joining the Commission. This appears to have launched him on a public speaking career that had him giving 60 speeches in 20 months. So, who knows what can happen?

One of the financial writers--obviously a man with space problems--asked me recently if I could characterize in as few words as possible what I thought the most crucial job of the Commission would be in the next few years. I don't remember if I was able to respond to that question then. Thinking about it now, I would say that the most crucial job of the Commission is to make the investment process work for the investor. This is behind most of our current priority concerns at the Commission. To cite just a few examples, it is the basis for our continuing programs to make the prospectus and other disclosure filings truly meaningful documents of information rather than treatments which read like something on the back of an iodine bottle. It is the basis for our concern about the cloak of informal procedure that surrounds the issuance of earnings forecasts by corporations--a cloak which we intend to pierce through rules and guidelines on forecasts. It is the basis for our dissatisfaction with accounting practices which obscure rather than inform, particularly about the quality of a company's earnings.

Making the investment process work for the investor is the thrust of the efforts by the securities industry, the Congress and the Commission to restructure the securities markets into a central market system. Most of you are familiar with this concept, which must become a reality. We at the Securities and Exchange Commission expect--and will do everything in our power--to make the central market system an operational reality within two years.

Tonight, I would like to outline the working principles of this system, as we see them. The details will be spelled out at much greater length in a White Paper the Commission will release within the next few days.

First of all, why do we need to restructure our securities markets? They are recognized as the best in the world. They are efficient. They do a formidable job of matching the buying and selling interest of millions of investors here and abroad. They can absorb huge blocks of securities, even when jittery institutions follow the principle of "first out, all out." For the economy, these active and vital markets provide a basis and a means for directing investment capital to the most profitable and to the fastest growing industries. They establish a framework for the raising of new capital. They are a prime national asset. Many of you in this room tonight can take credit for the current effectiveness of these markets and you should be commended.

But these markets in recent years have been taking new form at an incredible pace. There have been many reasons: the surge in institutional trading, the mergence of new markets to handle big blocks of stock, the sudden and sweeping shifts in the pattern of securities trading, the upheaval in the economics of the securities business itself. Today, the result is that for many securities there are now many markets--both on the exchanges and off the exchanges in the offices of brokers-dealers.

At any given time, the public investor sees only part of this picture. He is looking at a goldfish bowl while really living in the middle of an aquarium. There are many reasons for the separation of these markets, but few would make much sense to the public investor. For example, some of the exchanges display all of their trades as they take place. Other exchanges display some trades but leave out others. Markets off the exchanges generally don't display trades as they occur. Some of the securities markets operate under an extensive system of regulation. Others operate under lesser standards. Some exchanges try to block their members from taking business off the exchange.

Others don't have these barriers. Finally, and perhaps most importantly, there is no communications link really tying these markets together.

The major problem with all of this is that there is no way that an investor can be certain the investment process is working for him all the time, there is no way he can be sure his interests are being protected all the time, and that his order can be represented in all of these markets all of the time. This means that the public investor has no assurance that his broker is getting him the best available price on his order--wherever that may be.

The central market system will give the investor's order constant protection and representation in all of these markets at the same time. We view it as a communications and regulatory system with three parts: first, a network for reporting prices and volume as trades occur so that all the action in a given security can be viewed through a central source; second, a quotation system to capture and display all the bids and offers in these securities so the broker can see where the best price is available and direct the investor's order to it; third, a regulatory framework to assure that the purposes and goals of the system are met.

The pieces of this new market picture are beginning to fall into place. On March 2, the exchanges and the National Association of Securities Dealers filed a joint plan for a trade reporting system. The Commission will announce its views on the plan later this month and expects a full trade reporting operation to be running by the end of this year. A quotation system plan will soon be under development by the securities industry and we hope that network will be in operation as early as possible in 1974. The regulatory structure, our third concern, was the focus of a report released on March 6 by the Industry Advisory Committee on a Central Market System. This 10-member group, representing a wide range of securities firms, was split in its approach. Half of the group felt that the central market system should be allowed to evolve from the present market structure so that regulation would emerge in response to needs pointed up by actual experience. The other half felt that regulatory revision and active direction were needed in the near future if the central market concept is going to work.

In the Commission's view, the vast differences in the purposes and operations of the many markets which will be tied together in this system demand new regulation and system direction. It is true that much of the regulatory framework will evolve with actual experience in the system. But in our judgment, three basic working principles must be incorporated into the system as soon as possible: first, preference and protection for public orders; second, direct and open competition between all markets; third, system integrity -- guarding against manipulation of prices and other potential abuses.

I. Preference for Public Orders.

We believe the best features of the exchange auction markets must be preserved in the new market system. Exchanges operate under the principle that purchases should be made by the highest bidder and sales by the investor offering his securities at the lowest price. In addition, these are markets where much of the time brokers are acting as agents for others. In other words, they are markets where the professionals mainly serve other investors. The rules of a typical exchange auction market are set up to favor and encourage public orders. In the central market system, it is essential to encourage public orders and to match these orders, whenever possible, with other public orders. To make this work, we propose two basic trading rules for the system.

The first rule would prevent any broker-dealer in the central market system from participating as principal -- that is, buying for, or selling stock from, his own inventory -- unless his purchase bid is higher or his offer to sell is at a lower price than any public bid or offer in the system. In other words, the dealer must do better than the best public order -- he must improve the market -- before he can take preference over a public order. So, if a market-maker were bidding for a stock, and a broker enters the system with the same bid by a public investor, the public order would be filled first. In effect, this rule would require broker-dealers in the system to surrender their present rights of priority based on time, and precedence based on order size, so that public orders can meet more often.

The second trading rule would protect limit orders. As you know, these are orders -- mostly from the public -- to buy at a lower price or to sell at a higher price than is current. Today, there is no way that a limit order left with a specialist on the floor of the New York Stock Exchange can participate in a transaction on the Pacific Stock Exchange -- even if the price on the Pacific Exchange moves to a level where that limit order could be satisfied. This will be changed in the new system. We contemplate that all limit orders would be stored in a closed, central electronic repository. Before a trade could take place anywhere in the system at prices away from the current market, the system would have to be interrogated and any intervening limit orders executed.

This would apply off the exchanges as well. In negotiated dealer transactions, particularly large blocks, unless the negotiated price is equal to the best bid or offer in the system, or is between them, the system would have to be interrogated and the public limit orders allowed to participate in the transaction at the favorable price. This means that investors could participate in the discounts and the premiums that take place when large transactions are executed at prices away from the current market. This potential bargain may serve to encourage limit orders, which we hope will lend stability to the market.

II. Competition.

Competition is our second working principle. To make money, market-makers have to attract volume. To attract volume, they have to provide service to customers and outbid their competitors. This enables investors to buy for less and sell for more. The ultimate beneficiary of aggressive competition among the market-makers is the investing public.

The Commission's concept of the central market system involves open and direct competition between all the market-makers in listed stocks -- not only the exchange specialists but the non-exchange dealers, the so-called third market-makers. We see no reason to require membership on an exchange as a condition for participating in the central market system. New and sophisticated market-making techniques and large pools of capital have developed off the exchanges to meet the demands of increased trading by institutions. We want to bring them into the central market, to put them to work for the investor. Competition should decide where the orders flow. If the best market in a stock is on the New York Stock Exchange, the specialist there should -- and will -- get the business. If it is on the floor of the Pacific Exchange in Los Angeles, the specialist there will draw the orders. If it is in the office of a market-maker off the exchange, then that's where the business should go. We have spent too much time breaking down barriers to competition to allow new barriers to appear in the central market system. We want the chips, that is, the profits, to fall where they may in fair and open competition between the markets.

But fairness demands comparable standards of accountability and responsibility. The Commission will adopt rules to require the regional exchanges to submit plans which set standards for specialists of the kind in effect on the New York and American exchanges. We will also adopt a rule to require the NASD to file a plan for the regulation of its third market-makers in a way comparable to that for specialists. The guiding principle will be to impose responsibilities that are commensurate with the benefits realized by the participation of these various market-makers in the system.

To promote competition, the Commission is considering changes to put the specialists and the third market dealers on more comparable ground in dealings with institutional investors. Rules of the New York and American exchanges now bar specialists from accepting orders directly from institutions. However, other securities dealers, and the specialists of some regional exchanges, are free to deal directly with institutions. Where the prohibition exists, the specialist simply lacks the feel of the institutional market that is available to his competition. The specialist also may be reluctant to assume the risk of a large position because of his inability to work directly to liquidate such a position. We are contemplating a limited departure from the structure these rules have imposed.

The Commission will propose that the New York and American exchanges consider modifying their rules to permit specialists to deal directly with institutions on orders of block size. As I've indicated, this is an experimental approach. The effect of modifying the rules should be carefully monitored by the exchanges and the Commission. Assuming no significant problems are observed, the stage could be set for a more substantial revision of the rules -- perhaps leaving the prohibition against direct dealing by specialists with customers to apply only to corporations and their insiders -- after a system of truly competitive market-makers has developed.

Competition between markets does little good if a broker can't take a customer's order to the best market. The start of the central market system will require the elimination of rules such as Rule 394 of the New York Stock Exchange which hinder a member's ability to take an order to a non-exchange market-maker. Brokers will not only be able -- but they will be obliged -- to look beyond their own market centers to meet their responsibility as agents for their customers.

Assuring a free flow of orders also requires a realistic incentive for the thousands of brokers in this country to direct orders properly within the system. Under today's rules, a broker who wants to take an order to an exchange where he is not a member must pay a professional commission to a member of that exchange. This amounts to about 60% of the fixed public commission rate. There is plenty of evidence that even these reduced professional commissions are being circumvented and an even larger share is being returned to non-members through complex arrangements involving reciprocal business on various exchanges. This indicates to us that the present professional discount is still too low. In fact, all of this -- the need for complex reciprocal arrangements, or the sacrifice by a non-member broker of a substantial portion of the commission he has earned -- really works contrary to the basic factors on which all competition should be based: obtaining the best securities price and giving the best service to the customer.

The professional access to all markets I am talking about is closely tied to the issue of commission rates. If all exchange brokerage rates were fully competitive and not fixed as they are today, each broker could negotiate his own access to any market center. But the question of fixed rates has yet to be fully resolved. It is our hope that the exchanges themselves can deal resolutely with the rate issue that has plagued us for so long. If this question is not resolved by the time the central market quotation begins operation, or if the exchanges have not worked out arrangements for meaningful access in some other way, we will require that each exchange substantially expand the scope of negotiation on rates charged non-member brokers. In other words, we will require a significant increase in the permissible level of economic access for brokers to all exchange markets.

What about the effect of lower commission rates on exchange membership? If any qualified broker can take his orders to an exchange and have them executed at a cost that is not much different than what a member pays, why would anyone want to belong to an exchange? This concern involves the self-regulation exchanges impose on their members and the viability and efficiency of the marketplace afforded by the exchanges. Both of these play a major role in today’s securities markets. If exchange memberships lose economic value, will brokerage firms leave the exchanges? If they do, will self-regulation and the exchange trading mechanism be the worse for it?

In my judgment, after considerable reflection, as long as exchange’s specialists provide competitive markets, business will flow to the floor of that exchange. The incentive to belong to that market -- at least to act on its floor -- will remain strong. Apart from floor membership, and whether or not the firm is a member of an exchange, any firm dealing with the public has the duty to get the best possible execution for a customer’s order. This means, for example, that whenever a quote in a security is more favorable on the New York Stock Exchange, the broker must take the order there -- whether he is a member or not. If the New York Stock Exchange, the primary market for listed securities, continues to provide competitive markets, it will continue to attract orders at today's levels or higher.

The theme of competition will be reinforced by our trading rules. Even firms who might wish to take most of their listed business off the exchanges and act as dealers with their customers -- a form of "upstairs" market-making -- will find it difficult to do so. All trades will have to be displayed publicly. Trades away from the current market will be subject to the auction process through the clearance of the limit orders in the system. In addition, the dealer who wants to trade directly with the customer would have to better any public order represented in the system. In short, we believe neither reduced professional rates, nor fully competitive rates, -- nor permitting the trading of listed securities off the exchanges -- will have great effect on the trading mechanism provided by the exchanges.

As to the self-regulatory structure, a key approach in this whole question, it seems to me, is to tie the benefits of exchange access to the regulatory responsibilities involved. I would urge the exchanges to explore new concepts of exchange membership. One example is associate membership in effect on the American Stock Exchange. Here an associate member pays a relatively small initial fee, plus a periodic assessment based on commission earned. In return he gets access to the market at a basis close to that of full members. Associate members are not allowed to be present on the floor. But they are subject to the same kind of regulation as members. This is one approach which would appear to give meaningful access to all qualified brokers without jeopardizing the self-regulatory structure. Others can be developed.

I have explained why I don't think increased exchange access will impair the attributes of our system, even if it removes some of the incentives to exchange membership. Many argue, too, that the prestige and goodwill associated with membership on a major exchange with a commitment to investor protection should provide ample incentive to retaining membership. This is particularly so if a firm's regulatory responsibilities would not be appreciably diminished by resigning its membership. Under they system we envision, they would not be.

III. Integrity.

Integrity is the third working principle of the central market system. We want a system that is free from manipulation and that provides comparable standards for trading practices and financial responsibility, so that competition is based on price and service rather than the avoidance of regulation. We will establish uniform regulation of short sales in all markets within the system. We will direct the exchanges and the NASD to develop a coordinated approach to trading suspensions. We will see that the system is backed by a sophisticated and vigilant surveillance program to guard against misuse. And we will seek to establish a comparable regulation of all market-makers in the system, including specialists on the regional exchanges and the third market people. Thus, the competition we all want will be fair competition. After all, if we can't demonstrate some competitive prowess in the securities markets, what can we expect from the rest of the economy?

These working principles for the emerging central market are both necessary and practical. We must maximize the flow of public orders to the market through full disclosure of all trades and quotes and through trading rules which give the public investor full representation in all markets. We must make competition a reality by setting up fair and comparable standards and obligations among the competing market-makers, by erasing barriers to the free flow of orders, and by providing all broker-dealers with real economic access to all the exchange markets in the system. We must insure the integrity of the central market system through an effective body of regulation.

In my judgment, the central market system will do a lot for the investment process in this country. It will strengthen a national resource that may be the last great advantage this nation enjoys in world economic competition. It will improve the ability of corporations to mobilize capital. Most important, it will establish a new bridge between the securities industry and the public investor. There is evidence that the securities business has lost touch with the investor. Perhaps part of the reason is that it is difficult to make much sense out of the mosaic of securities trading today. The central market system makes sense. Its concepts are clear, fair and understandable. Most important, with this system, the public investor is assured that the markets are working for him -- that he has an equal crack at the best available price, no matter where it is being made.

Thank you.