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THE FUTURE OF THE AMERICAN EQUITY MARKET

An Address by

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I am grateful for this opportunity to talk to you tonight about our equity markets. I don't have to tell this audience about their importance to our economic progress and to our competitive vitality in the world. I do want to tell you what I believe to be necessary if these markets are to maintain their primacy and their value as a unique national asset. This by itself will take the time alloted to me and I will not embellish. The name of this game is confidence, responsibility and integrity. When I talk about stock market commissions, about memberships on exchanges, about disclosure of transactions and dissemination of quotations, I am concerned about the health and profitability of an industry. But I am more concerned about the confidence of a people and the economic thrust of a nation.

Some people say we are at a crossroads. We can go the European way of concentrating savings and economic decisions in a relatively few institutions or continue on our own way to a broader and deeper people's capitalism with economic values determined and decisions made by a more informed and more sophisticated investing public guided by professionals. I like to think we are a little beyond that crossroads -- at least in the sense that we know where we want to go and have made the first moves.

As I have assessed our equity markets and their future, I believe that we need to do many things but these three are paramount:

1. Develop a truly national securities market operated through and served by the best communication and information facilities that modern technology has to offer.
2. See that this market is operated by professional market makers and brokers committed to serving the public in those capacities and held to the highest standards of responsibility and fiduciary obligation.
3. The companies whose shares are traded in that national marketplace must continue to meet the constantly refined and elevated standards of uniformity and comparability in accounting and fairness in financial reporting which a more informed, more sophisticated and more professionally guided public demands.

All this translates itself to public confidence and continued forward movement in keeping the investor in the American equity markets the most informed and the best served investor in the world. That's what makes it possible for our corporations to command more capital for a dollar of earnings than their competitors abroad, to plow back earnings which their competitors abroad have to distribute in order to maintain their capital values and to raise larger amounts of capital more quickly in order to apply more rapidly and on a larger scale the technology we have shared and the markets we have opened to the world.

I would be a Pollyanna if I didn't recognize the troubles and the problems that our equity markets have had in the recent past and right now. Indeed, that's why I so keenly feel the need for constructive action right now. Let me tell you what we intend to do.

Over the last five years the proportion of trading in listed stocks which is not disclosed has doubled. Today the SEC is issuing for comment a rule which would require all exchanges and the NASD to submit plans for real time disclosure of all transactions in listed stocks in all markets. This will for the first time give us truly nationwide disclosure of prices and volume in listed stocks.

Today also, we have promulgated a rule which will call for all exchanges and all over-the-counter market makers to make their bid and asked quotations publicly available. This will be the basis for a truly national market in which investors will know where they can get the best price.

To make this market system work and to insure that this expanded disclosure of transactions and quotations does not mislead there will have to be a greater degree of commonality in the rules and regulations governing trading. While the disclosure rules I have announced tonight are being implemented, a three-way effort to develop the rules needed for a central market system will be under way. First, the Commission has directed a staff study of the existing rules of all exchanges on trading on and off-floor by members, on activities and responsibilities of specialists and market-makers, unlisted trading privileges, on short sales, and other trading practices which can result in distortion or manipulation of the market-place. This staff study will be gathering and evaluating information while a committee made up of the heads of the various self-regulatory bodies will continue their work to develop proposals for rules required by comprehensive transaction and quotation disclosure and a central market system. At the same time, the Commission will be receiving directly the recommendations of an advisory committee on the rule changes needed to assure market maker responsibility, access between markets, proper interface between exchange and over-the-counter and between dealer and auction markets and other steps necessary to make competition as well as technology work for investors.

There are two other areas in which we must put technology to work for investors.

Today, at the SEC in Washington we run the biggest goldfish bowl in town. Some 10,000 corporations financially undress four times a year. Notices of significant developments and insidertransactions are filed in the tens of thousands. All this information is available for all to see. Last year, some 900 firms, analyzing securities, hunting for prey, snooping on competitors, questing for greener grass or whatever, tapped this horde of information to the tune of some 100 million pages on microfilm and some two million pages of hard copy.

I believe much more can be done with this information. Let me tell you what we're doing to make this information more current and get it out of our morgue to where the people are and where decisions are made. We have just about completed the computerization of insider transactions and delinquency checks on the filing of corporate reports. Last week, we invited the firms which have over 50,000 quote boxes out around the country to use our computer tapes. With our tapes in their computers, these 50,000 boxes can tap our files and make information instantly available on call at

50,000 locations around the country. On any of the 10,000 companies filing information with us, that black box could tell not only last price and volume, but whether any insider sales had been reported, where that company had filed one of the 13,000 reports we receive every year on a material development affecting value, whether the company is up-to-date in filing its regular financial reports. There are new horizons of information and confidence here and I believe we can reach them.

If the Federal Reserve had not required magnetic ink on checks years ago, we would not be able to handle the number of checks our economy requires today. Similarly, I believe that unless we apply modern technology to our archaic methods for handling securities, we will not be able to handle the volume of transactions arising from our capital requirements in the second half of the seventies. The banking and securities industries are making good progress in reducing the movement and transfers of certificates.

We have recommended to the Congress that the Commission's authority over the execution and clearing of securities transactions be extended to depository and transfer functions so that there will be central authority and responsibility to guide the development of a fully modernized nationwide system for the transfering and paying for securities.

I'm pleased to see the sense of urgency on this front indicated by the 1976 deadline set for eliminating the certificate in transactions between brokers in a bill Senator Williams just introduced.

Information builds confidence. But to be useful, information has to be evaluated and analyzed and then judgment has to be applied to arrive at investment decision. This function is performed by a corps of some 15,000 securities analysts, unique in the world, and by investment advisers and managers, within and without this corps of securities analysts. Some investors do it for themselves, others use advisors, others rely on brokers, still others pool their savings to get professional money management through institutions. Whoever does it, this is the critical function for investors, for companies in need of public money and for the nation in the allocation of its resources of capital and talent.

In a pluralistic and diversified society like ours, all routes should be kept open. Indeed, if we are to preserve the vitality of our markets and avoid a centralization of economic decision and control in a relatively few institutions, all routes must remain open.

When we look to see what is happening in this respect, we find that almost 75% of all stock is owned by individuals, while a little over 25% is owned by institutions. But we also find institutions accounting for over 60% of the buying and selling in our securities markets. Whereas ten years ago, a trade of 10,000 shares or more occurred about 4 or 5 times a day, today a block of 10,000 shares or more is sold and bought every 3 minutes, mostly by institutions.

I don't have time to address myself this evening to the problems raised by this institutionalization of the securities market. The SEC spent $1,000,000 and produced 10 volumes analyzing these problems. Suffice it for the moment to say that it can radically alter our markets and our economy if growing institutionalization is not offset by a broadening peoples' capitalism. To achieve this, individuals must have the assurance that institutions do not have an inside track in the markets and in the information and guidance available to them.

This leads me to the critical need to expand and improve money management services and the controversial problem of institutional membership. We are told that institutions want exchange membership to save commissions and that they will lose interest when fixed commission rates are eliminated on trades of institutional size.

We hear a lot about the recapture of commissions for beneficiaries. What are the facts? In 1970, the 65 largest mutual funds, having assets of 46 billion dollars, recaptured less than five and a half million dollars for their beneficiaries. That's a dollar on every $9,000. If we look only at the funds which do the best job of recapturing for their beneficiaries, they save a dollar a year on each $2,500 they invest. Yet, even if these funds lose only a mere eighth of a point in market price on their trades in the contortions they go through to save commissions, their beneficiaries lose a lot more in the value of their holdings than they save in commissions.

I submit to you that in the controversy about institutional membership we have at issue a relatively small amount of dollars which some institutions may save against the strength, the vitality and even the integrity of our equity markets.

After two months of hearing some 80 witnesses and much study, all five members of the Securities and Exchange Commission arrived at the judgment that the interests of all investors and all who have a stake in our national economy call for a market structure served by brokerage firms having the principal purpose of serving the public.

We saw dangers in any institutional membership but concluded that an institution wishing to commit capital and take responsibility for providing brokerage service for the public should be permitted to do so. But we found it harmful to extend exchange privileges to shell broker-dealers, without any execution capability, created by institutions or their managers solely for the purpose of recapturing commissions through a variety of convoluted devices rather than providing any useful service to the investing public. There are some 4,000 institutions managing portfolios of $15,000,000 or more. It is difficult to see why some of these institutions should have the benefit of reduced commissions resulting from institutional membership and others should not. So long as institutional membership is permitted without any significant commitment, the logical consequences of the court decisions and legal advice that there may be an obligation to recapture commissions could produce thousands of institutional members and radically alter our capital markets with incalculable consequences to individual investors and all who have a stake in the American economy, including the institutional investors themselves.

The gyration of these shell brokerage firms have already made our markets too complicated with too many transactions structured, contrived, and carried out in a particular place or in an unnatural way.

We believe that elimination of rebative and reciprocal practices and of exchange memberships which do not have a primary purpose of serving public customers will significantly benefit all investors, including the institutions themselves. As we move away from reciprocal and rebative practices and bring transactions into the open, we will focus attention where it should be -- on where and how to get the best price for a buyer or seller of securities. We believe that investor confidence will be strengthened as professional attention is reconcentrated on finding the best market, providing information and judgment for the investor, and getting him the best net result, unclouded by considerations relating to the rebating, the redirection and the recapturing of commissions.

I am frank to say that this institutional membership question is a particularly difficult one to deal with. Bills have been introduced in Congress to abolish it and to confirm it. Some think institutions which become members early enough should be grandfathered in. While legislative action is pending, some stock exchanges are actively soliciting institutional membership and lawyers are advising institutions that they may incur liability if they don't utilize this opportunity to evade fixed commission rates. There is no assurance that this legal pressure will dissipate when the level of fixed commission rates is brought down, as it will be very soon to $300,000, and then, in one or two steps, to $100,000 if it continues to appear prudent to remove an umbrella under which this industry has operated for over 100 years.

Despite these difficulties, we believe that the Commission has a clear obligation to require the exchanges to eliminate membership which is primarily a rebate mechanism without any significant obligation to serve public customers. There will be Congressional hearings to which we will be very attentive and to which we will contribute in any way we can. If the Congress chooses to, it can decide this issue in any way it considers to be in the public interest. In the meantime, the Commission has to proceed in its traditional way to use its authority to do what it finds necessary to protect the investing public.

Historically, it has been the Commission's task to eliminate, or at least limit, the special trading advantages which any one group of investors may hold over another so as to establish honest and fair markets in which all public investors may act on investment decisions with confidence. Accordingly, the Commission has required the major exchanges to adopt regulations restricting members' trading on and off the exchange floor and to impose restrictions and affirmative obligations on specialists.

The trading advantages which accure to an exchange member are considerable. He may trade for his own accounts at the intra-member rate or without the payment of any commission charge, enabling him to take advantage of minor short swing price fluctuations by in and out trading. In a recent quarter, one type of institution turned its aggregate portfolio over at the rate of 50% a year. Moreover, a member receives a constant input of trading information from the floor and from other members. He has an intimate feel of trading conditions -- for example, the size and nature of volume -- in the market as a whole and in particular securities. This knowledge, combined with an understanding of the ways in which market professionals such as specialists and block positioners acquire and work off large positions, enables the member to maximize profit on his trading decisions.

Perhaps even more importantly, the member can make and implement trading decisions much more quickly than members of the investing public because of his proximity to information sources and, if present on the floor, his access to the specialist's post.

Institutionally affiliated broker-dealers which seek exchange membership solely to trade for their affiliated institutions not only contribute nothing to the public purpose of exchange markets but add a vast degree of trading power to that group of investors already having troublesome advantages over the general public. Indeed, membership in and access to an exchange by any broker-dealer seeking to trade for its own or its affiliate's account -- without being required to participate in the handling of public transactions, without having any special function which contributes to the viability of the exchange market (such as a market maker or arbitrageur) and without undertaking any obligations in relation to the operations of that exchange -- raises fundamental issues of public policy as to whether the public purpose of exchange markets is being properly fulfilled.

The Commission's market structure statement has been criticized for not going far enough. Some say we should have flatly prohibited any transactions between an institution and a brokerage affiliate which is primarily dedicated to serving an unaffiliated public. It may be that this is the proper solution to the many dilemmas which confront us in dealing with this thorny situation and we may well get to that. In the meantime, I would certainly not advise an institution to acquire a brokerage firm counting on that firm handling most of its transactions. Apart from creating difficult problems in determining whether it is properly meeting its fiduciary obligations and in negotiating commissions with itself, it may wake up some day to find that Congress has concluded that the situation calls for creating a complete barrier between an institution and the execution of its portfolio transactions. The Commission was constrained from reaching that conclusion at this time by considerations of economic impact and of fairness as between brokerage firms created by institutions and brokerage firms which themselves have created institutions. In addition, we were mindful of the fact that Congress had had occasion to review the investment company - broker relationship and had not abolished it.

The money manager-broker conflict is not fundamentally different from many other conflicts common in the securities industry and elsewhere. The most basic of such conflicts -- that of the combination of broker and dealer functions -- was thoroughly reviewed by Congress and by the Commission over 30 years ago and left intact. I infer from this that Congress must have concluded, as we have concluded, that in most cases it is preferable to disclose and regulate a conflict rather than risk the economic consequences of tearing apart an industry.

There are potential conflicts of interest of all combinations of the money manager and brokerage functions, as well as the broker-underwriter, the money manager-underwriter, and the dealer-money manager functions. If all of these functions were to be separated, the capital-raising capability of the industry and its ability to serve the public could be significantly weakened.

Looking at brokerage firms which engage in the money-management business, we believe that those members of the investing public who invest directly rather than through institutions are in need of additional money management services and that the experience member firms have accumulated in the area of money management can be essential in meeting this need. We also think it important that a portion of broker-dealer income be based on a more stable source than commission business. It is clear to me that there is a far greater public interest in encouraging the money management services which brokerage firms are capable of developing for individual investors than there is in encouraging institutions to commit their capital to the brokerage business. Nevertheless, we believe we have arrived at a formula under which institutions will have an opportunity to diversify by entering the public brokerage business, thus providing needed new capital in that sector, while at the same time broker-dealers will remain able to diversify their business so that more stable money management income will increasingly balance off fluctuating brokerage income, and their brokerage customers will not be deprived of their money management experience.

Since we did not at this time opt for a total ban it will remain our obligation to frame a rule which will minimize potential conflicts and see that they are both disclosed and controlled. We believe that more serious potential for conflict exists where the money manager, not otherwise engaged in the brokerage business, joins an exchange not to act as a bona fide broker-dealer but solely for the purpose of directing commissions from a captive advisee to its own benefit. Accordingly, we concluded that our decision to require that members conduct a predominantly non-affiliated business would have the effect of eliminating those cases where the problem is most acute.

Admittedly, it is difficult in some instances to determine whether a broker-dealer has joined an exchange in order to serve the public or to take advantage of the conflict; however, we feel that as long as the proportion of business required to be done with unaffiliated, public accounts is sufficiently high, new entrants will be required to make a significant commitment to fulfilling a function which benefits the investing public. Such a member firm will have a fiduciary obligation to a broad range of customers and a direct and immediate economic stake in preserving public confidence in the exchange markets.

Let me leave it that this knotty problem on institutional membership and money management is an evolving one. I believe that the solution we have proposed will eliminate the most immediate and serious dangers and move it in the proper direction. My optimism is based on the conviction that we will do what has to be done and that there can no longer be any doubt that the great and fundamental need is to move towards a central market system and an increasingly professionalized brokerage and money management community. This is not only desirable, but mandatory if we are to meet the nation's demand for capital, remain economically competitive in the world and maintain our preeminence among the securities markets of the world.