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REMARKS OF

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before the

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"RESTRUCTURING THE SECURITIES INDUSTRY"

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The health of the securities industry and the outlook for its future is of more than passing interest to all Americans. The role the industry plays in the economic growth of our country can hardly be over-emphasized. The existence of capital markets has been instrumental in enabling small companies to become industrial giants. It has enabled many other private enterprises to remain viable, and as a result, the economic and social benefits to the country have been overwhelming.

The availability of private capital to municipalities and other agencies of government has resulted in similar, far-reaching benefits. Schools have been erected, mass transportation facilities constructed, recreational areas created, and a greater number of public facilities and services made available to meet the needs of a society whose living standard continues to be the highest in the world.

In the light of these facts it is easy to understand why the infusion of private capital into municipal or corporate endeavors is so important to economic and social development under our system of free enterprise. It is literally true that such investments constitute an investment in the future of America.

In all of this the securities industry plays a key role because it is the medium which serves all parties concerned -- corporations, agencies of government, and investors. And this brings up a very important point. If there is one single, over-riding responsibility of the industry, it is at all times to protect the best interests of the public. To assist the industry to administer and police itself, Congress passed the Securities Exchange Act of 1934 which lodged self-regulatory power in the exchanges and the National Association of Securities Dealers.

Contrary to what many may think, the self-regulatory responsibility granted the securities industry extends beyond the basic objective of establishing policies and practices intended to insure that investors have equal opportunity and are protected against fraud. It includes the responsibility not to ignore any and all opportunities to increase operational efficiency so that reasonable profits can be realized at the least cost to investors.

Unfortunately, little concerted effort is being made within the industry today to fulfill this responsibility.

This would be sad enough to contemplate if nothing were involved but a reluctance to depart from traditional ways of doing business. The fact is, however, we are seeing a reluctance to recognize reality -- a reluctance to acknowledge that the industry as structured today can't possibly improve its efficiency to the point where the investor can benefit substantially. And let's not pretend that investors are unaware that something is wrong. Or that they can be persuaded indefinitely that nothing can be done about it.

On the contrary, it is evident that what is needed and what most certainly will come to pass in the near future is a radical restructuring of the securities industry as we know it today. And this newly-shaped industry will achieve operational economies surpassing anything in the history of the industry because it will also process all transactions with the most modern equipment available.

Before going into detail, I want to devote a moment to the subject of self-regulation because a basic understanding of it is essential to any discussion of the securities industry. And by way of definition, when I use the term "securities industry, I mean brokers, dealers, trading markets, and the self-regulatory organizations which, as I have said, consist of the exchanges and the National Association of Securities Dealers.

At the time these organizations were granted self-regulatory authority, Congress also created the Securities and Exchange Commission. The SEC is responsible for regulating the securities markets under the guiding principle that it is the self-regulatory agencies who are primarily responsible for setting the ground rules for the industry, so that an absolute minimum of government intervention is required.

That principle is so important -- particularly in view of what I have to say to you today -- that I want to present it to you in still another way. It is the responsibility of the securities industry first to attempt to solve its own problems. It is the responsibility of the SEC to assist, and ultimately, to approve or disapprove of certain of the industry's decisions.

Today we have an industry that does not disavow its responsibility first to attempt to solve its own problems. But we do have an industry whose proposed solutions to these problems seem more often designed to temporize, rather than to come to grips with the basic issues involved. And half-hearted measures simply won't suffice any more. Investor unhappiness with the surcharge and the impetus from some quarters for eliminating fixed commissions should make it crystal clear that the costs of executing security transactions must be reduced no matter how drastic the steps required.

No matter in what direction these steps are initially made, they will inevitably lead to a restructured industry whose outlines can already be described in considerable detail. Before attempting to do this, I will first review the current structure of the securities industry.

At present there are four types of securities markets: the exchange markets, the over-the-counter market (OTC), the so-called "third market" and the comparatively new fourth market. The fourth market is composed of investors who trade directly with one another without an intervening broker or dealer.

The exchange markets are auction markets where a seller and a buyer who never meet exchange their assets at a mutually agreed price. Their interests are represented by exchange members who are paid a commission for their services in finding the other side of a transaction. Many times, however, the other side is not an investor but a "specialist" who is a member of the exchange charged with specific responsibilities -- the most significant of which is to "make a market" in one or more securities. In return for assuming this responsibility, the exchange grants a sole franchise to the specialist by virtue of denying any other exchange member the opportunity to make a competing market in the same security. Thus the exchange markets are in reality a group of auction markets maintained by a series of specialists who are required to "make the markets" in all of the securities listed on a particular exchange. Further, all transactions are consummated at a specific location -- on the "floor" of the exchange.

The OTC market, the second type of securities market, is a "dealer" market in securities which are not "listed" on any exchange. The OTC market is classified as a "dealer" market because public orders are not matched as in the exchange market but are executed with "market makers" who are on the other side of every transaction. To illustrate, an investor who wishes to buy or sell an OTC security instructs his broker, as in the exchange market, to find the best price. The broker does this by canvassing individual "market makers" in the security. Unlike the exchange specialist who exclusively makes the market in a particular stock, there are usually many "market makers" in OTC securities. Furthermore, they are located all around the country, not on the floor of an exchange.

Unlike the specialist again, the "market maker" is not required to buy or sell a security in which he makes the market. In practice, however, because of competition and reputation, a "market maker" usually will either buy or sell on request. This lack of obligation on the part of the "market maker" to always "make the market" can be, and is viewed by some as a serious deficiency of the OTC market.

The "third market" is composed of dealers in securities who perform the same functions as market makers in the OTC market with one important exception. Whereas the OTC "market maker" buys and sells securities which are <u>not</u> listed on an exchange, the third market maker, who himself is not a member of an exchange, buys and sells only securities which are listed on exchanges. Thus, because the same securities are traded in each market, the third market and the exchange markets are in competition with one another.

Now let's look at the industry as I believe it will inevitably be restructured. There will be exactly two markets. One will consist of an amalgamation of the existing exchange markets. The other will be made up of the present over-the-counter market and will be operated by the NASD.

The two markets will be in direct competition. Specifically, each will be competing with the other in terms of efficiency, liquidity and depth. Both the large and the small investor will be free to shop. And that's when we're going to see an all-out effort to give them the most for their money.

That's the basic outline. Now let's look at some of the details.

All existing exchange organizations would be combined into a stock corporation. The shares of the new corporation would be issued to all members of exchanges pro-rata based on the respective values of their seats. Simultaneously, the existing exchange organizations would transfer their net assets and operational and self-regulatory responsibilities to the new corporation and go out of existence.

A plan with similar objectives would be adopted to place ownership in the hands of the members of the National Association of Securities Dealers, which will be registered as a national exchange.

Thus, each market will be self-regulated and initially owned by its members. What's more, there will be comparability of regulation within a viable competitive framework.

Each market will have the right to determine whether to trade a security. However, it will be up to the issuer of the security to determine in which market the security will be traded exclusively. This decision should be left to the issuer because it is an important property right. Further, this procedure will create much-needed competition in supplying such shareholder services as transfer facilities, mailing of shareholder reports and payment of dividends as well as in the market making function.

Both market systems will be fully automated. To illustrate, let me give you an example of how a buy order will be executed.

Upon receipt of the investor's instructions, the broker will initiate the transaction simply by pressing buttons on his desk computer console. First, he will want to "find the market" among competing specialists. Then, before the information is actually transmitted, it will be displayed on the broker's console for verification. He will then press the "execute" key. Within seconds in most cases, which will be simultaneous by today's standards, the specialist will execute the "buy" order from "sell" orders on hand, or from his inventory.

Once this is done, the computer will perform the following operations:

- The transaction will appear on the "tape."
- A form automatically will be printed combining confirmation of the transaction -- bank debit advice -- and memorandum of stock ownership.
- The purchaser's bank account will be charged.
- Appropriate entries will be made in the corporate shareholders' records.
- The information will be stored in the computer's memory bank and will be printed out for bookkeeping records when required.

So much for the general outline of the structure and operations of the securities industry that lies ahead. Some people will say that it represents an ideal that can never be reached because of the complexity of the problems involved in making the changeover. Others will say that even if these problems can be solved, the effort would be a waste of time because a two-market industry would sooner or later be fragmented by the same pressures that are fragmenting the existing industry.

I don't agree and I'll tell you why.

First, let's take the matter of investor confidence and how it might affect a two-market industry. Today, disclosure requirements for almost all publicly held companies are substantially comparable. As a result, the investor does not distinguish the exchange markets from other securities markets on the basis of disclosure requirements. He has confidence there is comparability of disclosure, and bases his investment decisions on the future prospects of the issuer of a particular security. This attitude creates a freedom to structure the marketplace of the future that would otherwise not exist.

Next, there is the matter of the value of existing exchange seats. If Congress, the courts, or the SEC decide that access to exchange markets must be made available to all registered broker-dealers, I propose that present exchange members be compensated as follows:

Each member would receive one share of stock in the new corporation based on his pro rata share of the value of all stock exchange seats. His stock would be registered with the Commission and immediately made eligible for trading. His tax basis for each share would represent a pro rata share of the net book value of the new corporation. The difference between his share of the net book value and the higher of the market value of the seat on a set date or his original cost would be recovered by allowing the difference as a credit against his federal income tax liability. In addition, I propose that if such a decision concerning membership is made, a reasonable period be allowed within which to make the necessary adjustment from limited exchange membership to free access by all registered broker-dealers.

Another important matter for consideration is whether institutions should be permitted to become members of the two markets. Let me say first of all that reduced brokerage costs, together with the economies achieved on large transactions, would reduce the financial incentive for many institutions to join either market system. Of course, there will be those who would want to join simply to earn additional profits.

More to the point is the public policy question of whether institutional investors should continue to be denied direct access to securities markets because of regulatory objectives or considerations of economic concentration. These factors are so complex that more intensive analysis is required before a sound decision can be reached. But whatever this may be, it will not reduce the advantages or the efficiency of the two-market system.

Turning now to the subject of possible fragmentation of a two-market industry by the same pressures that are fragmenting the industry today, my view is simple. The totally automated industry of the future will be so efficient economically that there will be no incentive to go elsewhere.

As far as the cost of setting up and operating the two-market system is concerned, there is no question but that it exceeds the present financial capacity of the securities industry.

Therefore I propose that the cost of designing and building the computerized operational networks be funded by proceeds from the sale of previously unissued stock. Thus public investors, as well as broker-dealers, will have the opportunity to participate in the profits of the securities industry. These profits would flow from transaction charges and fees for shareholder services.

A logical first step toward the creation of the computerized operational networks is a feasibility study to establish the general systems design and computer configuration. I believe this is sufficiently in the public interest to justify the federal government bearing the entire cost of the study. Additionally, federal participation at the outset should result in a more objective system design.

I would hope, too, the feasibility study would consider the advisability of setting aloft a communication satellite to handle securities transactions from all over the globe. Our securities markets are the envy of the world. We should capitalize on this fact. A totally automated market, trading both domestic and foreign issues, could lead to a 24-hour market place which would accommodate the various time zones around the globe. This would lead to better markets and ultimately to an increase of dollars flowing into our treasury. The resulting increase in our balance of payments would substantially benefit our country.

Now I have not attempted to go into the manifold legal problems involved in restructuring the securities markets in the manner I have described. This isn't because I am not aware of their existence. Quite the contrary. But of legal problems let me say this. The securities laws of the federal and state governments were made by men. They can be amended, repealed and rewritten by men. To say, after years of debate, that legal problems still exist is indicative that only minor efforts have been made to seek the assistance of responsible law makers throughout government. I am sure they would respond swiftly to the requests of the industry where the national interest is involved.

In conclusion, I have one final observation to make concerning the value of a two-market system as opposed, say, to a three-market or one-market industry.

A three-market system, even if modeled exactly along the lines I have described for the two-market concept, would not add any material element of competition. So the investor would gain little or nothing from it. But the additional federal oversight required would cost the taxpayers that much more money. And finally, I don't think you'll find anyone who can come up with even one good reason why such a three-market system would make sense. I wish I could believe that enthusiasm would also be lacking for a one-market system.

I find it incredible that speculation exists that the industry should deliberately be restructured as a single, central market. Monopoly is tolerated under our free enterprise system only when no feasible alternative exists. And how anyone can believe monopoly breeds efficiency is beyond me. But efficiency would hardly be our greatest concern if a single, central securities market existed. Instead, we would all be marking the countdown to the day the federal government took over the securities industry. And the consequences of the federal government of a capitalistic society taking over its capital markets could well provide history with its first example of a nation which committed suicide by devouring itself.

As far as I am concerned, we must leave the ownership of the securities industry in private hands. What's more, the regulation of the industry must be left in the private sector, subject only to federal oversight, as it is today.

I do not mean to imply that I consider the self-regulatory system has worked to perfection in the past. I wish it had. And I don't mean to imply that as presently constituted it will work to perfection in the future. As a matter of fact, I am completely agreeable to a review of it for the purpose of improving its future effectiveness. What is important is that the concept of self-regulation be maintained. The securities industry, like other industries, may falter and stumble along at times, but again like other industries, it has its men of vision and ability. Their voices can and will be heard, and with the assistance of all concerned within and without the government, they will lead the industry to a new era of profitability and fulfillment of its public responsibility.