REMARKS OF RICHARD B. SMITH, COMMISSIONER
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# "Three Needs"

Ladies, gentlemen, distinguished guests from the Chicago financial community, I deeply appreciate the invitation to speak at this dinner, on this evening, in this place. It is important in these days when so many claimed divisions among us are voiced, that we remember the essential things that unite us. Especially should we do so gathered here in the heart of America.

Surely we must acknowledge that our religious heritages, which once perhaps seemed so momentously different, have more common than disparate roots. And what greater common strength do we have than our Constitutionally embedded direction to value the diversities of belief, and race, among us. We have witnessed in our lifetime all too graphically what exclusions and antagonisms and lack of mutual respect between Gentile and Jew, Catholic and Protestant, white man and black man, can do to our humanity.

Cannot all Americans be brought to feel they are a part not only of our country but of its private capital system? None should be left to feel excluded if they will to be included. There are a growing number of examples of special assistance being given both by the private and public sectors, but there is more all of us in the financial community can do to assist and assure such participation. It can come in many ways -- in inner city housing and minority enterprise investment, in special training and employment programs, and others. For the sake of the country, we cannot afford to let ourselves be discouraged by the massiveness and frustrations of the task. The capacities, the remarkable ingenuity of the people in this room are profoundly needed to find ways to move private capital processes more effectively into these areas. In the words of Peter Drucker,[1/] "it is an ethical demand on business to convert into profitable business the satisfaction of social needs and wants."

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1/Drucker, The Age of Discontinuity (Harper & Row 1969) 205.

It is easy in times such as these, when there are such intensive pressures within the financial community itself, to forget the calls beyond. While I should like to speak during the remainder of my time about some aspects of change within the securities industry, I hope none of us will forget the wider demands upon us.

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Times of intensive change intensify the need for perspective and common goals. Yet it is in the midst of such times, as we have now, when the best policies to achieve the public purpose and the national interest are most difficult to discern. There are the dual temptations. On the one hand, the temptation to sit back and watch problems evolve, to do nothing and hope the problems somehow, magically, work out or that someone else, miraculously, will solve them. On the other hand, there is the temptation to define problems simplistically and apply superficial, ready-made solutions, mainly just to give the appearance of doing something.

Present circumstances do not permit either such course. Both the financial community and its regulators are being called upon to find and demonstrate the most encompassing view of the public interest.

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The changes occurring in the securities industry are affecting its historic organization in ways not yet fully fathomable. The Commission is presently studying and dealing with different aspects or parts of a basic question: What shall be the character of our securities market? Because of the complexity of the question, because all parts of it cannot be decided at one time, and because undoubtedly new developments will occur that will require adjustments of earlier decisions reached, I suspect the Commission's focus will be required to remain in this area for some years to come. The forums for study and decision-making by the Commission are various: the commission rate structure hearing, the Institutional Investor Study, enforcement proceedings and rule proposals under the 1934 and 1940 Acts, specific rule changes submitted by the self-regulatory agencies; and there is the legislative process.

Since I shall be discussing current issues, I express no final views and offer no solutions tonight, nor do I intend to reflect the thinking or approach of other members or staff of the Commission.

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I think it is fair to say that a prime and unique characteristic of the American capital markets has been its centralized trading structure for massive amounts of equity securities. Unique, because it is so different from the fragmented, decentralized, relatively small volume stock markets that have existed in most parts of the world. While there are few who contest that centralized markets as we have known them have been a strength of our system, there are more who question whether all elements of the historical primary marketplace are essential to it, and whether we should have any concern about their possible loss. For instance,

--The Justice Department has questioned whether minimum commissions are necessary to preserve a central marketplace. Whether one agrees with the Justice Department cure or not, there can be little doubt, in fact, that the rigidity over the last decade of the New York Stock Exchange commission rate structure contributed itself to fragmentation and market inefficiencies.

--Over-the-counter market makers who deal in listed securities, the "third market," have questioned whether they should be restricted in their opportunity to trade off-board with exchange members. Long ago, regional stock exchanges questioned whether listed trading should be restricted to the primary marketplace and won the argument as to them when the Commission in the early 1940s permitted dual and multiple exchange listings.

--Some institutional investors have questioned their exclusion from direct access to the primary marketplace, and have taken steps to gain closer access by joining some regional exchanges. This has been countered by suggestions that all exchange memberships be limited to brokers who are excluded from any investment advisory relationship to institutions.

--Some specialists on the primary exchanges are apparently beginning to question whether they should not trade directly with institutional investors, whether or not institutions become members of the exchange. And some member block positioners and large integrated firms are questioning whether they should not become specialists on the primary exchanges.

--Finally, some smaller broker-dealers have questioned whether they should not be able to have some form of direct economic access to the primary marketplace without going through the reciprocal business route.

Underlying at least part of these questionings are rather differing approaches to what constitutes the best form of market.

There are those on the one hand who assert that a dealer market provides the best pricing and liquidity. By a dealer market, I mean a market where the bulk of orders brought to it are executed with a dealer as principal on the other side of the transaction. The over-the-counter market operates this way. A dealer market has traditionally been evaluated on the presence of competing market makers, and the assertion is that a number of dealers competing in their quotations for orders provides the narrowest spread in bid and offer prices and consequently the best market. It is argued that the existence of competition among dealers provides the best assurance that price changes will not be erratic and that liquidity will continue to be provided even in a depressed market. A dealer, of course, trades on a net basis; that is, without commissions.

The exchanges, on the other hand, have proceeded on a different basis. They assert that the best and most efficient market is created by concentrating a flow of agency orders on the exchange. The larger the flow of orders from customers, the narrower the spread becomes. Dealer participation, in this view, should only exist where there is a temporary imbalance of agency orders and the purpose of dealer participation should be stabilizing. Such dealer participation is a relatively regulated one that requires the specialist to make a continuous and orderly market and give priority to the agency orders of public customers. Such self-regulated, as distinct from competitive, obligations are usually today performed by a single specialist for each security. The exchanges say --

at least the primary exchanges do, and regional exchanges with respect to solely listed issues -- that the ideal competitive model for securities transactions is where all the potential buyers and sellers from everywhere are brought together and compete through their agents, the brokers, in open auction. They believe it essential to a fair market that all transactions be promptly and publicly recorded, and that prospective buyers and sellers know the volume and last sale price as well as the current spread between bid and ask. An agency market, of course, is sustained by the payment of commissions to both sides of the transaction.

These are very different views of the way securities markets best function.

The strongest elements, the most structured, in the industry's self-regulation have been those associated with the agency markets. It is true that these markets, the national securities exchanges, have never been purely agency markets -- some member firm principals do trade for their own account, some member firms trade for in-house funds they manage, and specialist participation has been growing to some extent in recent years. Nevertheless, the main handle for industry self-regulation has been control over the agent rather than the principal. The Commission itself emphasized this agency role on national securities exchanges by its concern about floor traders (who trade for their own account), and increased regulation was imposed on them not so long ago. The exchanges emphasize the responsibility professional broker members have to the integrity of their marketplace. They believe this responsibility counterbalances whatever duties they may have to their principals, duties that otherwise might act to the detriment of other participants in the marketplace.

With the impending introduction next year of NASDAQ, the automated system for displaying over-the-counter quotations to be administered by the National Association of Securities Dealers, it seems likely that a more structured form of surveillance and self-regulation of the dealer market will evolve. The over-the-counter market would then take on some of the characteristics of the exchange markets. In terms of disclosure of trading information, in some respects it will be less complete and in other respects more. Current volume and last sale will not be displayed to customers, but the current median quote (and not just the last sale) will. In terms of a centralized marketplace, the electronic communications network will provide simultaneous nationwide information, although actual executions would occur as at present in bilateral negotiated dealings, mostly by telephone, with a market maker.

Today the agency and dealer markets exist relatively separate and apart from each other. To the extent they compete with each other and among themselves for trading in the same security, it is conceivable they could work at cross purposes and negative the advantages of each -- by diffusing the depth and flow of orders that give any particular market its strength, by creating opportunities for highly sophisticated investors to profit from disparities in the various markets at the expense of ordinary investors.

How can competing marketplaces be prevented from being selectively utilized by traders to the detriment of public investors, or from devolving into the least common denominator of protection for investors? Is it possible for these developments somehow to be coordinated into a cohesive and strong securities market system, yet one with a sustained capacity for innovation? Is it possible to have a centralized market system that is not bound by historic concepts of a single trading floor? There hardly seems to be any technological reason why various trading places cannot be brought into a single market system. This may not have to be inconsistent with conserving and building upon existing institutions that have served the capital growth of our country well. I am not suggesting elimination of any exchanges; that would be pointless -- I am suggesting that systematic thought might now be given to the possibilities in time of transforming our market system into a larger whole.

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Nothing substantial changes abruptly and few changes are unequivocal. Nevertheless, it is apparent that the new electronic technology (such as NASDAQ typifies) will be sternly affecting the nature of our markets. Automation, for example, is also being applied experimentally to specialist's books, operationally to aspects of odd-lot dealing, and generally to the paperwork underbelly of the securities industry in the central certificate depositary and in various clearing house systems.

Peter Drucker has pointed out the value of looking for what he calls "discontinuities" from the flow of the past, that demonstrate difficulties or outmodings of existing ways of doing things and point to new organizational directions of the future. Automation technology is certainly one that underlies others in the securities business. The growth of institutional investment is another. Increased institutional activity in the markets may subject existing market structures to increased or different stresses in a number of ways.

In the first place, institutional investment decisions by a relatively small number of institutions may be more homogeneous than comparable investment decisions with respect to the same securities by numerous individual investors. Since most institutional investors either rely heavily on research ideas from the broker-dealer community or supplement their own in-house capabilities from that source, many institutions may be considering the same investment ideas at the same time. The high degree of specialization in broker-dealer research tends to stimulate this phenomenon. Moreover, if professional investment management does offer high increased changes of success, institutional investors should be more likely to reach similar conclusions from the same information than would less sophisticated individual investors.

A high degree of homogeneity in institutional investment decisions would have serious implications for the securities markets. Market stability flows from disagreement among investors. Absent this diversity, the securities markets would either always be extremely volatile or virtually nonexistent. There is little that could be done to adjust the market mechanisms to cope with a high degree of homogeneity.

The pending Institutional Investor Study will attempt to measure the extent to which institutions tend to be on the same side of the market in particular stocks at the same time --what has been called parallel trading. The Study has collected data for an 18 month period on the monthly purchases and sales of 800 common stocks by some 300 major institutions. Although the final analyses are not yet complete, preliminary results indicate a much lower degree of homogeneity than many people would perhaps have expected.

Even if institutional investment decisions are not significantly less diverse than investment decisions by individuals, there are necessarily fewer of them. To the extent that these decisions are implemented rapidly in block transactions rather than gradually over longer periods of time, they may subject the markets to spurts of trading pressures rather than more continuous flows. In other words, block trading has the effect of increasing the size of orders, decreasing their number and lengthening the time gaps between them.

It is not altogether clear whether, given a high degree of institutional stock ownership, block trading is a better or worse method of implementing institutional investment decisions. Because market makers must take on larger commitments to stabilize block markets and must wait longer to dispose of those commitments, their function becomes a considerably more risky one. On the other hand, cleaning up a large institutional order all at once rather than allowing it to overhang the market for long periods of time may facilitate the market maker's job by stimulating the opposite interest necessary for him to dispose of his commitments.

Large position changes may be effected by institutions by block trades on the major stock exchanges, on regional exchanges or in the third market, or by a series of small transactions mainly on the major exchanges, or by various combinations of these trading methods. Each method has a different market impact. If block trading is an efficient method for implementing some or all institutional investment decisions, then consideration must be given to whether the structure of the markets is adequate to handle block trades and whether the existing market makers -- the specialists, block positioning houses and third market firms -- have been given the proper tools to handle their job. I adverted earlier to some of the questions that have recently been raised by market makers and others in this respect.

Another major stress created by the increase in institutional investing is on the insulating layer of professional brokers between public customers and the marketplace that is an important ingredient in the protection of the individual investor. It appears that a number of institutions either do not want that protection at all or are unwilling to pay the current price for it. Moreover, increased participation in the equity markets has stimulated some institutions to seek entry into the general securities business in addition to eliminating the brokerage costs on their own portfolio transactions. Thus, affiliates of some institutions have joined regional stock exchanges, some institutions have made extensive use of the third market, and many institutions have exerted pressure to reduce or retain current commission rates. The topic of institutional membership is under careful study now by a variety of different bodies.

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There are two other conditions I would like to mention that generated needs to go beyond, in some respects, existing decentralized organizational arrangements. One is the fails problem that has led to joint intra-industry and banking-securities industry involvement in replacing the archaic system for transferring ownership of securities. The other is the concern about the financial condition of broker-dealer firms that has led to proposals to make Federal funds available to insure customer accounts against failure of broker-dealer firms, either by means of the Commission or a separate non-profit corporation.

You are familiar with the serious fails problem that the securities industry had during 1968 and 1969. I have spoken elsewhere, as have many others, about the problems of the stock certificate.[2/] The massive increase in securities market activity outpaced the existing methods for transferring and delivering stock certificates, an event still deemed necessary for consummating securities transactions. Each serious study of the problem such as the North American Rockwell report[3/] and the Lybrand study[4/] emphasized the inability of any single unit in the financial community -- whether it be securities firm, exchange or bank -- to solve the problem by itself. Neither could regional efforts, whether in New York or elsewhere, alone accomplish the task.

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2/R. Smith, A Piece of Paper, Vol. 25 Business Lawyer 923 (1970).

3/North American Rockwell Information Systems Co., "Securities Industry Overview Study, Final Report to the American Stock Exchange" (1969).

4/Sidney M. Robbins, Walter Weiner, Craig G. Johnson, Aaron Greenwald, Lybrand Ross Bros. & Montgomery, "Paper Crisis in the Securities Industry: Causes and Cures. Is the stock certificate necessary?" (1969).

A recognition that the expanded needs of the markets required new organizational arrangements was reflected in the decision that the National Association of Securities Dealers would take the responsibility for organizing a national over-the-counter clearing system. This was an entirely new type of undertaking for the NASD. It is approaching the problem by seeking to utilize for over-the-counter securities clearing facilities at the organized exchanges. Arrangements with the American Stock Exchange on the East Coast and the Pacific Coast Stock Exchange on the West Coast have been effected. Hopefully, arrangements with the Midwest Stock Exchange for the center of the country will soon be made. These would then be linked up to a national system that is vitally needed. Thus, the necessities of the marketplace are bringing about coordination between the over-the-counter and exchange organizations.

Recently, a new banking and securities industry committee, called BASIC, has been organized with a permanent staff. Its members include the chief executives of three banks, two exchanges and the NASD. Its objectives are to eliminate paper work, streamline operating procedures and apply advanced data processing systems to the processing of securities transfers. This committee, again, is recognition that the accomplishment of necessary tasks for the operation of modern securities markets requires a pooling of efforts beyond the reach of any particular group or marketplace.

This is not the place to discuss the pending legislative consideration of investor protection insurance, because the Commission Chairman will be testifying about that shortly. I will only say that such protection, in the most economical form possible, should be provided for investors who are customers of broker-dealer firms. I mention this only to note that here again a new organizational structuring is likely to result because it is contemplated that customers of <u>all</u> registered broker-dealers will be covered and because there will be a very large Federal pledge of funds.

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I have tried to talk to you this evening about three concepts, none of them unique, but, I submit, worth keeping in mind. One is the need of the financial community to look outside itself to the urgent needs of our cities and minorities and to bring the dynamics of private capital to bear on them.

The second is the need of the financial community to look within itself and find a more encompassing view of a central marketplace for the nation that can absorb all our parochialisms into a stronger whole. The third is the need of our existing institutions to recognize the new discontinuities that are occurring in the financial world and to exploit their promise rather than to await the fate they bring to institutions that will not adapt to them.

I believe there is reason for some optimism on all scores. The genius of America has been to do, albeit belatedly sometimes, what has to be done in the best interests of all and to pragmatically adjust its existing institutions to the new realities.

Thank you.