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THE IMPACT ON THE INDIVIDUAL INVESTOR OF A CENTRAL AUCTION MARKET SYSTEM FOR LISTED SECURITIES

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As the securities industry moves closer to establishing a central market system for listed securities, there is, perhaps understandably, considerable jockeying for position among the prospective market components. Much of this maneuvering is purportedly aimed at developing a central market structure that will provide the maximum competitive interplay among participants. But over the past year, a great deal of dust has been raised under the guise of fostering competition.

The time has come to re-examine the concept of competition in the securities markets -- not in the relatively narrow sense of giving or denying specific advantages to one or another segment of the industry, but in the broader and more relevant context of what will benefit the public most.

The essential question is not whether Doakes & Co. will prosper in a central market environment -- although Doakes & Co.'s concerns and problems should not be ignored. The real issue is what kind of central market system will give John and Mary Doe the best possible opportunity to participate confidently, and on an equal footing with every other investor, in the central mechanism of American capitalism.

A major problem facing Congress and the regulatory authorities, therefore, is to determine logically, and on the basis of the most accurate available information, the kind of central market system that will best serve the public and national interest. Congress has been grappling with this issue for several years, hearing and sifting conflicting views and weighing them against its own assessment of the public interest. The debate has not always been characterized by logic or candor -- but it has certainly been useful in clarifying the issues and in bringing us to the threshold of determining what a central market system should really be and do.

NARROWING THE DIFFERENCES

Much of the debate has involved the prospective relationship of the third market -- the primarily institutional over-the-counter market in listed securities -- to a central auction market system. At the outset, the issue seemed to turn entirely on whether the third market should be permitted to continue operating outside the regulatory structure that governs trading and disclosure in the auction market, or whether it should be integrated into the central market system.

In recent months, however, there have been indications that the two views may not be irreconcilable. Indeed, the areas of disagreement have narrowed to the point where a leading third market spokesman could tell the House Subcommittee on Commerce and Finance:

> "I know of no third market maker who would not yield to the priority of the [Exchange specialist's] book. I know of no third market maker who would not want his transactions printed on a consolidated tape. I know of no third market maker who would not be willing to be subject to equal and fair regulation with exchange members."

Similarly, the Assistant Attorney General in charge of the Antitrust Division of the U.S. Justice Department -- an agency that has not always endorsed the views of the New York Stock Exchange -- told the same House Subcommittee that "in the long run, we believe that a single set of competitive rules should probably be applied to all markets."

If, as these statements suggest, questions of disclosure, of equal regulation and of priority and precedence for public orders can indeed be reconciled -- and if ongoing efforts to automate all but the human decision-making aspects of the trading process prove successful -- then we will move a good deal closer to creating a system dominated by competition on the basis of best execution. And Doakes & Co. will have every opportunity to compete -- on that basis -- for John and Mary Doe's security business.

THE CRUCIAL ISSUE: RULE 113

To be sure, despite the indications that the third market recognizes and acknowledges the importance of preserving and strengthening the auction market, significant issues still remain to be resolved. Perhaps the major remaining disagreement concerns New York Stock Exchange Rule 113 (and a parallel American Stock Exchange Rule 190).

Rule 113 bars Exchange specialists from dealing directly with institutions in their specialty stocks. The relationship of this rule to a central market system is somewhat complex, and the various ramifications of either retaining or rescinding the rule need to be better understood.

The rule was originally adopted following the recommendation of the 1963 SEC Special Study of Securities Markets that specialists' market-making responsibilities and activities could lead to conflict-of-interest situations if they were also permitted to deal directly with the public. No similar prohibition exists for regional exchange specialists, third market-makers or block positioners -- primarily because in the existing regulatory environment, their responsibilities for maintaining continuous markets are either minimal or non-existent.

The effect of Rule 113, however, is to preclude NYSE and Amex specialists from competing directly for institutional business with market-makers in the third market and on regional exchanges.

If the third market remains outside the central market system but is granted access to the mechanics of the system -- as one proposed scenario would have it -- the result would be to place NYSE and Amex specialists at an even greater competitive disadvantage vis-a-vis third market dealers who <u>can</u> and <u>do</u> solicit and accept orders directly from institutions. The disadvantage to John and Mary Doe -- that is, to the public interest -- is that specialists would have a clear and strong incentive to withdraw from the Exchange so that they would also be able to do business directly as dealers trading with institutions. Since the leading third market dealers do not normally handle transactions for individual investors, the ultimate impact of any substantial exodus of specialists from the major exchanges would be to undermine the auction market where John and Mary Doe's transactions are executed.

On the other hand, if Rule 113 were rescinded and the third market remains outside the central market system, specialists <u>could</u> deal directly with institutions which might then view their fiduciary obligations as requiring them to deal directly with market-makers on a net basis. This would place member commission brokers at a competitive disadvantage vis-a-vis member specialists. And again, the implications go far beyond the prospective prosperity of Doakes & Co. -- since commission brokers would have a strong incentive to set up their own market-making operations in listed issues, to the ultimate disadvantage of the individual investor.

A CHAIN REACTION

Either way, the effect would be to promote a dealer market system that would have little relevance for John and Mary Doe. They would have to depend upon the diminished ability of an emasculated auction market to handle their transactions in listed securities -- or place themselves at the mercy of a dealer spread. The ultimate result would very likely be to impair the confidence of millions of individual investors in the market -- and to encourage them to curtail their participation in it.

Beyond this wholly undesirable impact, the withdrawal of millions of individuals from participation in the market could seriously damage the existing nationwide distribution network for new securities. This network, which provides American business with a constant source of essential new investment capital, depends for its proven effectiveness on a strong nationwide community of broker-dealers with ready access to the millions of individuals who comprise the American investing public. If this source of funds evaporates, the business community will be forced to rely almost entirely upon large institutions for fresh capital -- and the nation will face the potential dramatic reversal of broad public ownership of American business which has been so carefully nurtured and cultivated since the end of World War II. The problem would be compounded for smaller companies in which large institutions rarely choose to invest.

It is worth noting -- indeed, it is dangerous to ignore -- that this potentially devastating chain reaction would be triggered in the name of competition. But the effect of this particular concept of competition in the securities industry would be to freeze the public out of the securities markets and to concentrate the ownership of American business -- and investment decision-making -- in the hands of a relatively few enormous investors handling huge pools of money.

THE SIMPLE ALTERNATIVE

There is an alternative -- a very simple alternative -- which would preserve the competitive element among brokers and dealers and offer the prospect of strengthening public confidence in the investment process. This alternative involves nothing more complex than prohibiting all market-makers from dealing directly with institutions. This can be accomplished by integrating all trading in listed securities into the central auction market system and applying Rule 113 systemwide -- thus assuring the public and the business community of the complete impartiality of all market-makers within the system. The effect would be to require all brokers and dealers to compete for all securities business on the fair and equal basis of providing the best execution or orders. And John and Mary Doe -- the American investing public -- would be assured of fair and equal treatment with all other investors, regardless of size, in the world's most efficient and effectively regulated securities market.

SIGNIFICANCE OF THE AUCTION PROCESS

A curious feature of the debate on the structure of a central market system has been the attempt, in some quarters, to offset widespread recognition of the benefits of the auction process by suggesting that the process itself is not extensively used. To support this view, it has been suggested that the only genuine auction transactions are those executed for a public buyer and a public seller, between the bid-asked quote, without any intervention by an exchange specialist or other exchange member. And statistics have been cited to show that such transactions in 1972 involved a small percentage of all volume on the New York Stock Exchange. This contention, however, is misleading since it ignores the crucial fact that the specialist himself is part of the auction crowd.

The truth of the matter is that about 58-65% of all transactions on the Exchange are clearly auction market transactions -- executed either between brokers in the crowd, each representing a public order; or between one broker in the crowd and a specialist acting as a second broker's agent. And these transactions -- virtually all of which are executed for <u>individual</u> public investors -- involve about 45% of all volume on the Exchange.

The narrow view assumes, incorrectly, that when a public order on a specialist's book is on one side of a trade executed on the Floor -- that is, when a <u>public</u> limit order meets a <u>public</u> order in the crowd -- the auction process is somehow inoperative. This invalidly eliminates some 40% of volume and perhaps 55% of the total number of trades from consideration as auction market transactions. In fact, brokers in the auction crowd -- whether they are representing public orders or trading for their own accounts -- are competing through the auction process, for execution of their orders, with the limit orders on the specialist's book. The specialist, in such cases, acts as a broker representing all public orders to buy and sell at fixed limit prices -- in response to competitive bids and offers. In this capacity, he is acting, in reality, for a broker who has left the crowd, and he is participating in the auction process on behalf of that broker's customer.

Thus, the contention that a small percentage of volume is executed completely between public orders represented in the crowd on the Exchange Floor is not only incorrect, but it does not bear any meaningful relationship to the percentage of volume or transactions effected on the Floor as a direct consequence of the auction process.

Exchange members trading for their own accounts -- i.e., off-Floor members, including block positioners; odd-lot dealers executing round-lot offsets; specialists trading, as dealers, for their own inventories; registered traders -- in 1972 participated in another 45% of Exchange volume. However, in the vast majority of these instances, member brokers in the crowd -- representing public orders -- are competing, in an auction process, against the bids and offers of those member brokers who are trading for their own accounts. Clearly, the mere existence of the auction market is the controlling factor when, for example, the specialist buys or sells from his own inventory to accommodate a public investor at a price reasonably close to the current price, in the absence of any other public bids and offers. A very small proportion of Exchange volume -- an estimated 5% of the total -- may be accounted for by intra-member trades, i.e., trades between members in which no public order is represented on either side.

Pre-arranged block crosses executed on the trading floor are least likely to have an auction component, since the price has been negotiated before the transaction is brought to the Floor. However, Exchange policy requires that these trades be brought to the Floor where they are exposed to public limit orders on the specialist's book and public orders represented by commission brokers in the crowd. Thus, even here the auction process may operate to execute a public order to buy or sell at a price at least as good as that pre-arranged for the block cross -- or at a better price. In any event, the

Exchange estimates that pre-arranged block crosses accounted for about only 10% of reported volume in 1972.

The accompanying table indicates the relative proportions of share volume and transactions accounted for by the various types of activity described above.

		Shares		Transactions
Public orders represented in the crowd		45%		58 – 65%
a. Specialist's book on one side of trade -- public order in the crowd on other side	(40%)		(50 – 55%)	
b. No member intervention on either side of trade	(5%)		(8 – 10%)	
Member trading for own account		45%		35 – 42%
a. Public order in the crowd on one side	(40%)		(31 – 37%)	
b. Members on both sides	(5%)		(4 - 5%)	
Block crosses		10%		1/10 of 1%
		100%		100%

The table indicates quite clearly that the public investor is a participant in about 90% of the transactions executed in the NYSE auction market, and that the participation of these public investors is a factor in at least 85% of Exchange volume. Yet, even these percentages understate the importance of the public auction market. Essentially, all volume in listed securities -- including third and fourth market trades -- depends upon the auction market pricing mechanism which provides the definitive frame of reference from which transactions are developed. When the competing forces of public supply and public demand meet on the Exchange trading floor, the judgments of large numbers of public individuals, institutions and other traders undergo virtually instantaneous synthesis to provide a current bid and offer. Those judgments, reflected in subsequent transactions reported on the ticker tape, form the basis for evaluating and pricing securities in other markets -- not only in this country, but around the world. Where the volume of individual investment decisions converging on a central marketplace permits continuous trading in a particular security, the auction process is essential to maintaining an orderly ebb and flow of prices -- and to assuring that the orders of all investors are accorded fair and equal treatment.

THE PRIMARY OBJECTIVE

And it is precisely the extraordinary expansion of public activity in the listed securities markets over the past decade that has focused attention on the need for a more efficient central auction system. It follows inescapably that such a system must have as its primary objective the improvement of service to public investors -- and only then to accommodate as much as possible the particular concerns of elements of the securities industry which may find their own preferences not entirely in harmony with the needs of the public.

The Securities and Exchange Commission's views, as summarized in the Commission's widely distributed Policy Statement On The Structure Of A Central Market System -- issued March 29, 1973 -- appear consistent with this concept:

> "…the central market system will improve our existing system by bringing together all of our existing markets so that they are equally regulated and visible to all, and so that at the same time

> their members will be encouraged to compete, resulting in a substantial benefit for investors.
>
> "At the heart of a central market system…would be a comprehensive communications linkage between market centers, consisting of a real-time composite last sale reporting system and a composite quotation system displaying the bids and offers of all qualified market makers in listed securities."

The task of putting such a system into operation is, of course, far more complex than a simple statement of the objective might seem to suggest.

In involves, first and foremost, determining whether "competition" means structuring the market so that all classes of public investors have equal access to the services of broker-dealers who must compete for their business on fair and equal terms -- or whether "competition" really means devising some way of giving one segment of the securities industry or one group of investors clear advantages over others.

On a different level, the creation of a central market system involves tremendous technological challenges. Not the least of these will center on computerizing those aspects of public-order handling -- such as transmission, storage and display -- which do not require the exercise of human judgment, and meshing those elements with completely automated performance of all of the post-trade operations involved in the clearance, settlement and delivery of transactions.

The existing securities markets in this country, resting firmly on the foundation of the two-way securities auction process, have stimulated public ownership of business on a scale unmatched anywhere in the world. We have the conceptual and technological ability to improve performance through the creation of a streamlined and highly sophisticated central market system. The danger lies in the temptation to confuse improvement with mere change. To avoid that pitfall, we must examine each prospective innovation in the cold light of whether or not it will ultimately benefit more than 30 million individual public investors and advance this nation's economic interests.

The decisions to be made -- by Congress, by the regulatory authorities and by the securities industry -- must inevitably either strengthen or erode the securities auction market. The thrust of those decisions will determine whether or not a central market system can responsibly serve a vast and diversified investing public and enhance the preeminence of the U.S. securities markets among the competing capital markets of the free world.