

NEWS

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TO CREATE A FAIR FIELD OF COMPETITION

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Marc Antony's speech to his fellow Romans in Shakespeare's Julius Caesar contains the familiar lines, "Friends, Romans, Countrymen, lend me your ears; I come to bury Caesar, not to praise him." Unlike Antony, I come neither to bury nor to praise, but to express some of my thoughts concerning recent securities market structure developments, their relationship to earlier market patterns, and the manner in which competitive forces may serve as a catalyst in this area.

In just 47 days, on May 1, competitive brokerage commission rates become effective, and in view of the transition of regional exchanges from local markets to markets dealing principally in securities listed on a primary exchange, there are serious questions whether the regional exchanges will survive in a competitive rate environment.

Since their inception, regional exchanges have been buffeted by changes in capital market activity resulting from business cycles, basic shifts in the nation's economic and financial structure, and the development of communications systems which made small, local securities markets uneconomic units. The major regional exchanges which remain have survived by merging with other local exchanges and by providing competition with primary exchanges through creative and innovative services.

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Initially, regional exchanges developed as markets for local securities. But as local business enterprises expanded to regional and national concerns and sought listing on one of the New York exchanges in order to obtain national recognition and a broad national market for their securities, regional exchange business dwindled. To offset these losses, regional exchanges developed a practice of "multiple trading" whereby a trading market was provided for any security in which there was sufficient local interest, including securities not listed on any exchange, and this activity became a major proportion of regional trading and dollar volume.

When Congress was drafting legislation which later became the Securities and Exchange Act of 1934, consideration was given to prohibiting unlisted trading activity, but a compromise was reached which allowed unlisted trading to continue until June 1, 1936. At the same time, the Commission was directed to study this practice and report its findings and recommendations to Congress.

The Commission's study, transmitted to Congress on January 3, 1936, expressed doubt about the viability of regional exchanges if they were not allowed to continue unlisted trading. It indicated that approximately half of the trading volume on some regional exchanges involved unlisted securities and that about two-thirds of the shares available for trading on these exchanges had been granted unlisted

trading privileges.^{1/} Responding to the study's findings, Congress amended the Exchange Act in 1936 to allow unlisted trading to continue under certain limited conditions. The Senate Committee Report described the amendment as an "endeavor to create a fair field of competition among exchanges and between exchanges as a group and the over-the-counter markets and to allow each type of market to develop in accordance with its natural genius and consistently with the public interest."^{2/}

This statement of public policy has influenced significantly the Commission's decision-making over the years. Early Commission decisions generally permitted regional exchanges to trade unlisted securities after carefully balancing considerations relating to market factors in the region and in the primary market. In one such case, the Commission stated, "It appears that the applicant exchange has suffered seriously during recent years because of loss of listings and a lack of income resulting in substantial net losses during 6 out of the last 9 years. It was testified that expansion of trading on the applicant exchange is essential if the exchange is to continue in operation."^{3/}

^{1/}Securities and Exchange Commission, Report on Trading in Unlisted Securities Upon Exchanges, Appendix III, 30-37 (January 3, 1936).

^{2/}S. Rep. No. 1739, 74th Cong., 2d Sess. 3 (1936).

^{3/}Applications by the Cleveland Stock Exchange for Unlisted Trading Privileges, 6 S.E.C. 296, 304 (1939).

Later, in the landmark Multiple Trading Case, the Commission, using its 19(b) powers for the first time, ordered the New York Stock Exchange to amend a rule subjecting its members to disciplinary proceedings for dealing in New York Stock Exchange listed securities other than on that exchange. The Commission found that the rule would result in a curtailment of multiple trading and thus cause irreparable damage to regional exchanges. In its opinion, the Commission clearly supported the position that competitive markets are in the public interest and that the rules of an exchange should not be permitted "to impede the functioning of important instrumentalities of interstate commerce and to curtail or materially impair an important segment of the existing channels for the distribution and marketing in interstate commerce, of dually traded securities."^{4/} The Commission's 1963 Special Study also concluded that "the public interest is served by maintaining and fostering competitive markets as distinguished from having excessive concentration in a very few markets."^{5/}

During our recent 19b-3 hearings on whether the Commission should require the elimination of exchange rules fixing minimum commission rates, testimony was given to the effect that competitive rates should not be implemented until

^{4/}The Rules of The New York Stock Exchange, 10 S.E.C. 270, 287 (1941).

^{5/}Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. 950-951 (1963).

a consolidated transaction tape and a composite quote system indicating current bids and offers in all markets were operational. Without these elements of a central market system, we were told, regional exchanges would be unable to compete with primary exchanges because they would have no means of obtaining access to the primary order flow while, at the same time, the removal of minimum rates on primary exchanges would undermine one of the major reasons transactions in listed securities are executed on regional exchanges; that is, to circumvent the fixed minimum commission rates imposed by the New York Stock Exchange.

Our final decision, after carefully considering all of the testimony and comments, required the removal of barriers to competitive rates without any specific protections or accommodations for any marketplace. The Commission did indicate, however, that we would monitor market activity in order to be in a position to intervene if market forces were to bring about a result that was not in the interest of public investors or that jeopardized our markets for securities. Incidentally, yesterday the Commission approved for public comment a proposed monitoring program that would establish a reporting procedure to collect relevant data, which, as much as possible, would complement and interface with present regulatory reporting without becoming too burdensome.

In making the commission rate decision, the Commission was not unmindful of the fact that it would be desirable to have a consolidated transaction tape and composite quote system in operation when rates become competitive. For three years, since March of 1972, the Commission has been attempting to increase competition between market centers through the establishment of a consolidated last transaction tape and a composite quote system. Without "casting the first stone," because the Commission may not be blameless, the development of these elements of a central market system, which I believe are vital to "a fair field of competition," has been less than satisfactory.

The plan approach undertaken to develop a consolidated tape had some inherent disadvantages in that it required agreements of numerous parties on many difficult issues. There also have been problems in scheduling testing between regional market centers and the Securities Industry Automation Corporation. Nevertheless, we should see the composite tape operating with a full list of New York Stock Exchange securities by mid-June at the latest and a full list of American Stock Exchange securities by October. In addition, by October the high-speed transmission line should be available.

With this experience in mind, the Commission has concluded that the time required for the development of a composite quote system may be shortened significantly if

barriers to the broad dissemination of current quotation information are removed so that these quotes can be distributed to any person by any vendor engaged in the business of disseminating quotations for listed securities. Therefore, last Tuesday we sent a 19(b) letter to each national securities exchange formally requesting "changes in the rules and practices of your exchange to eliminate those which restrict, are interpreted to restrict or have the effect of restricting access to or use of such quotation information as is currently, or may be in the future disseminated by your exchange." We also requested that such action be taken to accomplish the necessary rule changes by May 1, 1975, to coincide with the date that competitive rates will become effective.

This action by the Commission, as was the case with the competitive commission rate decision, can be interpreted as an "endeavor to create a fair field of competition among exchanges and between exchanges as a group and the over-the-counter markets and to allow each type of market to develop in accordance with its natural genius and consistently with the public interest." It should provide all market makers access to quotes from all other markets in listed securities. For example, a specialist on a regional exchange will have the quotations of the New York Stock Exchange whether those quote are from the specialist or the crowd. This information should help the regional specialist to be more competitive and should

reduce his risk. At the same time, of course, the New York Stock Exchange will have access to information from other markets. Furthermore, quotes from all exchanges will be available throughout the country, and this will demonstrate to public investors and broker-dealers the extent and nature of the markets on each exchange.

Quotation information presently provided by some exchanges to their members may not represent the most current market on the exchange, but such information is, nevertheless, of considerable value to brokers and dealers, whether exchange members or not, in discharging their duties in connection with the execution of customer orders. Such information also may help individual investors and institutions to be aware of market prices and thus may assist them to make reasonable judgments as to which market they desire to patronize.

It is also expected that competitive market forces will provide an incentive to make the quotation information as meaningful and current as possible since available quotations are an important factor in making execution determinations. Certainly a market providing current quotes in size which market makers are willing to stand behind would have a competitive advantage over a market which does not establish firm quotations.

In view of the action taken under Section 19(b), there may be some questions regarding the status of the

Commission's Rule 17a-14 proposal, which, if adopted as proposed, would require the submission of composite quote plans for Commission approval. The Commission is deferring further consideration of the rule until we have had an opportunity to observe the response to our 19(b) letter, however, the proposal has not been withdrawn nor has it been abandoned. If the 19(b) letter, with or without subsequent action by the Commission, succeeds in releasing competitive forces which will bring about a meaningful quote system as was contemplated under our 17a-14 proposal, then further action on that proposal would be unnecessary. I sincerely hope that self-regulatory organizations, in their own interest, as well as the interests of the securities markets in general, will take advantage of this opportunity to make our securities markets more competitive without further government prodding.

The Midwest Stock Exchange has already announced that there have been arrangements to make its quotes available through two informational system vendors, Quotron and General Telephone and Electronics. I understand also that there have been discussions concerning the possibility of reporting Midwest quotes in the NASDAQ system. I am encouraged by these developments which should demonstrate to institutions, individuals, and other market participants throughout the country the extent and nature of the markets on the Midwest Stock Exchange floor. When this information becomes available at

the push of a button on the same terminal device indicating quotes in the same securities traded on other markets, it would seem reasonable that, in discharging execution responsibilities with diligence, broker-dealers may consider seriously interrogating your market. Furthermore, I believe that competitive forces could bring about a communications network providing a montage of listed securities quotations from all markets before the end of this year.

There has been much criticism of the Commission's actions with respect to the establishment of competitive rates, the elements of a central market system, and our relationship with the securities industry. We have been accused of "tinkering with the system" without understanding it and without having the interests of the securities industry and our capital markets uppermost in our minds. Although I sincerely respect the opinions of those who question our actions and can assure you that constructive criticism is not only beneficial but essential to us in our decisions, I firmly believe time will prove that the steps being taken by the Commission are not only in the best interests of investors, but also our capital markets and the securities industry.

Be that as it may, there have been several proposals for the creation of a new organization to facilitate the establishment, regulation, and governance of a central market system. These proposals range from an advisory committee under

the Commission's jurisdiction to an independent "super agency" which would act as a protector or benefactor to the securities industry as some believe the Federal Reserve Board is to the banking industry. Among the suggestions being given serious consideration is a legislative proposal that a National Market Board be appointed by the SEC to advise the Commission of steps that should be taken to facilitate the development of a national market system, and, if the Commission determined necessary or appropriate, under established rulemaking procedures, the Board would become a self-regulatory body under Commission jurisdiction with authority to "regulate and govern the system," as well as to assume unspecified "powers, privileges, rights, and obligations" presently possessed by national securities exchanges and associations.

Industry representatives have suggested that this proposal could lead to the nationalization of our securities markets. While this may be an unduly critical interpretation of the proposal, nevertheless, if one assumes SEC agreement, it seems fairly clear that responsibilities and authority of present national exchanges and associations could be supplanted and exercised by the National Market Board.

Another interpretation of the bill, however, could bring one to the conclusion that all that is being created is a formal Board to advise the Commission and thus facilitate the establishment and governance of a national market system.

One also could conclude that, if a satisfactory method of governing the system were to be established by system participants, it would be difficult, if not impossible, for either the Board or the Commission to determine that it was necessary or appropriate to centralize the governance of the system in the Board. Thus, the proposal could be read as providing an incentive for the industry to govern itself, and, if the industry failed to meet that responsibility, the SEC would exercise its authority to ensure that a central market system is governed properly.

An industry proposal also has been made that would establish a National Securities Market Board with industry representatives constituting a majority of its members. The Board would be given a legislative mandate to establish a National Market System and assure the vitality of the securities industry, authority to bring about the merger of existing exchanges, power to adopt rules for all exchanges and markets, as well as for clearing agencies, transfer agents and securities information processors, and a charge to coordinate all federal and industry agencies with respect to regulation of securities market participation.

In my opinion, Congress will not grant the sweeping powers recommended in this industry proposal to an industry dominated board, and I seriously question whether all of the proposed grants of authority should be conferred upon the SEC, or to any other government agency.

I do not believe that present securities markets should be forced to merge or that any of them should be eliminated by legislative fiat or that any organization should be established to bring about that result in contravention of economic forces. Competition among different markets is desirable and should operate to the benefit of public customers. Moreover, regional markets contribute to the economy of their geographical areas both through their own operations and by stimulating other financial activities. In addition, competition among exchanges, as in other endeavors, is conducive to innovation and improvement as each institution attempts to improve its competitive position. It is well recognized that regional exchanges have pioneered and introduced new ways of doing business, which, after proving themselves, have been adopted by others and have improved our securities markets.

The potential for such benefits in the future should not be ignored as proposals to unify our markets are considered. I realize that industry participants may feel frustrated in their attempts to increase efficiency and reduce costs, and I sympathize with them because we at the Commission frequently experience the same type of frustration. However, I believe that competitive forces can be instrumental in resolving difficult industry problems. In stressing the importance of competition, I do not want to be misinterpreted. I am not recommending a

simple physiocrat "laissez faire" policy in which there would be no government involvement or regulation. Indeed, competition is not a "cure-all" and regulation of our securities markets is necessary. But I do want to suggest that perhaps we should all step back and reconsider the philosophical and practical thrust of various proposals being offered. Perhaps we have been so disillusioned by the infighting between market participants that, in frustration, unnecessary and undesirable measures are being proposed. Perhaps what is really needed is more faith in the competitive system, which we claim to espouse, and perhaps we should give that system a chance to prove itself by removing barriers which unnecessarily restrict competition in the securities industry.

Perhaps, rather than attempting to prescribe a specific result, it is more appropriate to "endeavor to create a fair field of competition" by removing impediments not necessary or appropriate in the public interest or for the protection of investors and thus let our markets develop more in accordance with their "natural genius." In such an environment, the ability of the Midwest Stock Exchange or any securities market to meet competitive challenges will determine whether that market will be buried or praised.