<u>COMPETITION AND THE FUTURE OF THE NEW YORK STOCK EXCHANGE</u>

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There is an old forensic principle that speeches should never begin with a disclaimer. At the risk of violating that counsel, let me say that the concerns, assertions and questions which I will pose are expressed by me as an individual and do not necessarily represent the views of the Board of Governors. The policies of the New York Stock Exchange can be made only by that Board.

For 178 years the New York Stock Exchange has been the world's premier marketplace. It continues to be that today. Its reputation has been earned and is warranted by an admirable performance throughout the years. There is no other market which is so highly regulated, which discloses its activities so promptly, which oversees its members so closely, which sets such high standards on the calibre of issues traded, which monitors not only its members but its listed companies, which promptly disseminates price data and which provides depth, liquidity and continuity to the same extent to buyers and sellers of securities. Yet, I am concerned lest we bask solely in the glory of the past, and in the process become oblivious to emerging trends.

I am afraid we too often take for granted the benefits of a sophisticated, efficient central securities market. Without the New York Stock Exchange, our present standard of living would never have been reached. Our economy would function at a much lower level of activity, with capital in reduced supply and less impelled to seek out opportunities for growth. In a world which often sneers at the profit incentive, we may lose sight of the fact that we can afford to focus on improving the quality of life today precisely because our national affluence has made this possible. I take pride in the role our Exchange has played in the development of our economy and I urge you to consider carefully its continued importance to the nation's future growth and well being. It may well be that without the New York Stock Exchange, and the efficient allocation of resources it promotes, all the laudable efforts now going forward to reduce poverty, to restore better health to our central cities, to eradicate pollution, and to improve the quality of life, would be impossible.

Fragmentation of the Market

Despite prospects for higher volume, and we are planning for 17 million share average days in 1975 and 27 million in 1980, I am concerned about our loss of market share during recent years, and particularly, the last twenty-four months. Available figures point to unmistakable forces shifting relative volume away from the nation's central auction market to regional exchanges and the so-called third market, or over-the-counter market, where shares listed on the New York Stock Exchange are also traded. Many of you, as chief executives of your companies, keep close watch on your firm's percentage of the market. Naturally, I endeavor to do the same for the New York Stock Exchange.

Although the public interest favors increasing concentration of trading in a central securities market, available figures show that exactly the reverse is happening. For example, as recently as 1967, the regional exchanges and the third market combined to account for just over 10% of all trading in our listed stocks. Today they account for almost 20%. Thus, in the past three years there has been a doubling in the share of off-Board trading. One of the regional stock exchanges has trebled its market share in the last two years alone, principally as a result of block transactions. Available data indicate a significant loss of block trades, with an estimated 35% to 45% of 10,000 shares or more traded away from the New York Stock Exchange.

It is an unusual and interesting phenomenon that the market with the greatest degree of regulation, greatest capital, and the most impressive record for depth and liquidity should find itself being fragmented. I believe that the causes for this fragmentation are not related to any change in the unique economies of scale available on the Floor of the New York Stock Exchange but to the presence of antiquated and unequal rules and the emergence of a new environment for trading in securities.

One of the reasons for the present situation can probably be found in historical evolution. In bygone years, the New York Stock Exchange was the backdrop for a strong community of interest that existed between its floor, which processed business, and its so-called upstairs firms, which generated it. Because there were no other avenues open, the Stock Exchange could, by fiat and order, control the activities of its members. There was no other place in which to do business. However, as other market places have come into being, customers as well as members of the Stock Exchange have found it less necessary to place reliance on the primary marketplace. Trading in other markets, though not necessarily in the public interest, has served their ends.

The New York Stock Exchange, to put it crassly, no longer has the only game in town. The result has been a break in the similarity of interests between people engaged in floor activities, whose profitability depends on the share of business brought to our Exchange, and firms doing business with the public, who have become willing partners to fragmentation. For the fact is that most business is taken to regional exchanges by our own members.

Unequal Regulation

The fragmentation process, which has developed concurrently with the institutionalization of the market, has been accelerated by several other factors which are highly significant, not the least of which is the disparity of regulation of securities markets in the United States. It is human nature, and common to us all, to seek to play the game by the fewest or least restrictive rules, and unfortunately there are users of the marketplace who seek them out. To touch on a few, and with no wish to be technical, it makes little sense for the New York Stock Exchange to enforce rules against short sales in a declining market when there is no such prohibition in the third market. It is self-defeating regulation to permit customers to short stock in the third market without so stating and then to permit that stock to be resold as long stock in our marketplace. Additionally, the rules of the New York Stock Exchange governing the trading of specialists and floor traders have no parallel in the over-the-counter market. Off-Board trades are permitted by regional exchanges under less restrictive rules than ours. Unhappily, we have found that our prompt disclosure of price and volume data, which has no counterpart in any other market, redounds to our detriment. Some traders deliberately instruct brokers to execute orders on regional exchanges or take their business to the third market in order to conceal their activity from the public view. I am also concerned about lack of regulation in the recently developed "computer markets" which are highly susceptible to abuse and non-disclosure. Obviously, it does not serve the public interest to encourage investors to seek out a particular market because of a disparity in regulation. To correct the inequities of disparate regulation we need and solicit the aid of the SEC.

Significantly, some of the fragmentation of markets has been linked with the growth of institutional business and the Stock Exchange ban on "give-ups" or commission splitting in 1968. Our willingness to ban the give-up was prompted by the fear that the minimum commission concept was being undermined and by our wish to eliminate certain nefarious reciprocal practices. Our ban on commission splitting was accompanied by the representation from some of our government overseers to the effect that institutional trading practices would be monitored to see that commission splitting and reciprocity did not take other forms, a representation which to this date has not been implemented.

<u>Reciprocity and the Regionals</u>

Further, fragmentation has been accelerated by the proliferation of reciprocal practices in the securities industry today which, in my judgment, are not only threatening the central marketplace but are tending to undermine the entire moral fabric of a significant industry as well. I have been around long enough to appreciate the natural inclination to do business with those who do business with you. I deplore, however, the intrigues and machinations of some of our members and some of their customers. Bluntly stated, the securities industry, more than any other industry in America, engages in mazes of blatant gimmickry, all of which have been disclosed under oath at commission rate hearings. Deals are frequently involved, complicated, and bizarre and do no credit to the donor or beneficiary of the reciprocation.

I have no legitimate quarrel with any competitive success which is properly achieved by a regional stock exchange, and some of them have been innovative in a creditable manner. In the main, however, their success has been predicated on their willingness to adopt less rigid rules concerning institutional membership and/or to engage in reciprocity. As a result, these marketplaces, with little or no depth or liquidity, have become nothing more than rebate mechanisms to get commissions to those who do not qualify or to return them to institutions. On occasion trades are completed on other exchanges at worse prices than could be obtained on the New York Stock Exchange. Our members who will trade one New York commission for one and one-half or two commissions on another exchange, as well as people on the other side of the transaction, detract from the efficacy and liquidity of the central marketplace. The auction market functions best when it brings together the greatest number of buyers and sellers, enabling them to seek out the best price and the quickest execution.

There are at present numerous archaic and anachronistic policies and procedures which fail to respond to the needs of our industry undergoing the greatest change in its history. Subject to enabling legislation, if necessary, I believe we should pursue vigorously the complicated matter of providing non-member broker-dealers access to our facilities by means of a professional discount from the full public commission, as proposed by me in January 1968, and recently reaffirmed by the SEC as a desirable objective. Further, it might be appropriate for the Exchange itself to examine whether or not reciprocal practices of our members, in fact, violate our own rebate rules which say roughly that "thou shalt not give anything of value in exchange for a listed commission." And speaking of rebative practices, our Exchange itself might logically pursue the question as to whether the sanctioned practice of crediting commissions earned against advisory fees charged to customers is not, in fact, a return of commissions.

Fixed vs. Negotiated Commissions

This brings me to another policy issue bearing on the competitive position of our Exchange. I have already spoken about iniquitous reciprocal practices on regional exchanges and the growth of their market trading. These developments are not unrelated to the fixed minimum commission rates on the New York Stock Exchange trades, about which I would like to express a personal opinion.

For many years the members of the New York Stock Exchange have operated under a fixed minimum commission rate structure and the Courts have upheld the fixing of such rates under the Securities Act of 1934. There are even legal questions as to whether the Exchange or the Securities Exchange Commission, under Congressional mandate, can do other than set fixed rates. Just a few weeks ago, the SEC reached a number of conclusions on commission rates after two years of extensive rate hearings,among the most important of which was its advocacy of competitive rates on the portion of orders valued over $100,000.

Notwithstanding my own previous personal and strong support of fixed minimum commissions, I believe that it now behooves our industry leaders to rethink their personal judgments on negotiated rates. While I question whether or not the industry is presently sufficiently strong financially to completely disregard fixed minimum rates, I personally think it might well consider fully negotiated commissions as an ultimate objective. The initial emphasis might be put on larger transactions, and certainly larger than amounts stipulated by the SEC for a specified trial period. The results could be monitored and evaluated, and subsequent action could then be determined. I have altered my own personal thinking as a result of the commission rate proceedings of the last two years and the fragmentation of markets that has simultaneously been increasing. I should like, if

I may, to share with you some of my concerns to stimulate thinking on the subject.

First, in view of the increased emphasis that rates be reasonable, there is the concommitant responsibility to set standards by one method or another. No matter what the standard or criteria used, I believe the securities industry is being led down the path of utility-type regulation when it possesses none of the characteristics of a utility. This concern was further buttressed by the SEC's recent request for a uniform chart of accounts for the industry, to say nothing of the new concept of fixed rates, rather than minimums, which for the first time places a ceiling on charges. It is an anomaly that a regulatory body which genuinely professes no interest in rate-making should be importuned by many in the industry it oversees to have them do so.

Secondly, having personally experienced the laborious preparations for hearings and appreciating the task of those who must weigh, evaluate and adjudicate the matter as representatives of government, I wonder whether the inordinate delays and fantastic expenses result in a commission rate schedule which is responsive and timely. Depending upon the conflicting points of view, a fixed rate will be too high or too low the majority of the time, with corrections and adjustments being made at too slow a pace for at least one of the parties concerned. Better would it be for the industry to make its own competitive adjustments as economic conditions warrant, rather than to work on a new schedule as it has for almost eight years, with still no end in sight.

Unbundling of Charges

Thirdly, although I have argued that negotiated rates would bring about a degree of destructive competition, I now ask myself whether fixed rates have not brought about that very same kind of self-destruction. I speak to the indiscreet excesses of the past several years which may have been precipitated in part by the umbrella provided by the fixed minimum schedule. I inquire of myself as to whether overly-zealous service type competition and inept management has not been fostered by fixed minimum rates.

Fourth, I inquire as to the propriety of one commission rate serving all customers regardless of their wishes or needs or requirements for varying degrees of service. In that regard, it might be appropriate for our Committee to further pursue the matter of unbundling of charges, so that customers do not have to trade off-Board to avoid paying for unwanted services.

Fifth, it is difficult to appreciate the reluctance of some to negotiate rates when, in fact, many commissions are presently negotiated on the regional exchanges and in the third market. These negotiations have made a mockery of the fixed minimum rate concept and have produced various forms of reciprocation for institutions and non-member broker-dealers here and abroad, so that they are in effect paying a fraction of the fixed schedule. Perhaps it would be better to legitimize the entire practice.

Sixth, I personally believe that the introduction of negotiated commissions would speak significantly to the matter of institutional membership, for their main incentive in seeking Exchange membership is to save or recapture commission dollars. I believe, too, that reciprocity would largely be eliminated, for if an institution negotiated a commission which still allowed the executing broker to rebate, it might create a legal liability for having failed to negotiate a lower rate.

I realize that opposition from some of my constituents can be expected because as members of the New York Stock Exchange, and under the present industry structure, they have the best of both worlds in that they are afforded the protection of the minimum commission schedule on trades on the New York Stock Exchange while they possess the ability to negotiate commissions in other market-places, and to trade with insitutional members on regional stock exchanges to facilitate their recapture of commissions.

Staying Competitive

Net, I inquire as to whether the fixed rate concept, providing the basis for reciprocity and concurrently developing an incentive for institutions to recapture all or part of commissions paid, is not the single greatest reason for our market fragmentation. We can compete in only two areas, namely, service and charges, and I submit that no entity, not even the New York Stock Exchange, can forever ward off competition from a non-competitive stance so far as pricing is concerned.

Unless the New York Stock Exchange is willing to compete effectively with markets where commission fees are presently negotiated it faces a continued reduction in its share of overall trading, and at an accelerated pace. I submit it is not in the long term interest of our members or the public to permit a continued erosion in the liquidity of our marketplace.

The securities industry must, in addition to considering changes in the traditional ways of doing business, such as I have outlined, do whatever is necessary to meet the needs of millions of investors, present and future, large and small.

Restructuring the Exchange

The New York Stock Exchange, as the important institution that it is, must do the same, and an inward look seems timely. The Exchange as an organization, must keep in step with the times so that it continues to be relevant to today's and tomorrow's economic and social environment.

From the standpoint of our membership, bureaucracy at the Exchange should not be tolerated. Rules and procedures need to be updated and simplified so that Exchange regulation is administered with a minimum of bureaucratic detail and a maximum of regulatory and administrative efficiency.

Restructuring of the Exchange, as an organization, needs to go deeper than simplifying rules and regulations. The policy-making body of the Exchange, its Board of Governors, as well as the Exchange's voting and election procedures, should also be examined and restructured as necessary to meet the changing times in our industry. Whatever vestiges of a private club atmosphere which remain at the New York Stock Exchange must be discarded. Understandable economic biases and fear of dislocations must not impede necessary changes, as they so often do, but must be fused and melded to accomplish desired objectives.

In the near future, I will be presenting definitive proposals to our Board for a searching re-evaluation, codification, and simplification program along the lines outlined which, hopefully may lead to a major restructuring of the New York Stock Exchange. The Exchange must, in my opinion, do all that it can to be a most efficient, businesslike organization, responsive to the needs of the public and membership, if it is to continue to serve as the marketplace it has been for more than 178 years.

I have spoken with great candor which will alternately be applauded and deplored. I would entreat our members to harmonize the many diverse interests which make up the brokerage business, for it is my fear that we are tearing ourselves asunder and risking loss of our central marketplace in the process.

If our industry blunts its differences for the common good, and positions itself more competitively, this country will continue to enjoy the significant benefits of having a premier central marketplace for securities.

Thank you.