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FAIL-SAFE OR FAIL-CERTAIN: THE FINAL PUSH TO SECURITIES LEGISLATION

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I would like to try to clear up a few misconceptions this afternoon about the significance of securities legislation that is nearing a vote in Congress.

Until just a few weeks ago, I found it both disturbing and depressing that the corporate community did not seem concerned by -- or even, in many instances, aware of -- this legislation.

Most of the corporate executives I talked to over the past year took the lighthearted attitude of one who said: "Well, if Congress wants to zap the brokers, that's no skin off my nose." Except he didn't say "nose."

And to tell the truth, if that was all that was involved, I would have been hard-pressed to disagree. After all, most corporations have enough problems of their own these days without charging into Washington to help fight somebody else's battles.

Unfortunately, this is not somebody else's battle, and zapping the brokers is the least of it. We're talking about legislation that could have a profound impact on how all corporate stocks listed on stock exchanges are traded. And by "profound impact," I don't mean a change for the better.

The lack of corporate concern over the past months could only be explained by the simple fact that corporate executives did not realize the extent to which the proposed legislation might affect corporate financing and other essential activities. The New York Stock Exchange has been doing its best to bridge that communications gap. And judging by the groundswell of sentiment that is now developing, the message is finally getting through.

At the heart of the issue is legislation introduced by Senator Harrison A. Williams, Jr., of New Jersey, that would mandate the creation of a national securities market system -- a concept fully supported by the New York Stock Exchange. The system would link all trading in listed securities in a vast communications network designed to give public investors near-instantaneous information on stock prices and sales. Senator Williams' bill has already been approved by the Senate Banking Committee. Another major bill, introduced by Representative John E. Moss of California, is also moving toward a vote in the House Subcommittee on Commerce and Finance.

<u>Impact on Investor Confidence</u>

Our principal problem -- and it's a whopper -- arises from an independent decision by the Securities and Exchange Commission to end fixed commission rates on all securities transactions after April 30, 1975. The implications of the impending changeover to competitive or negotiated rates -- in the context of the pending legislation -- are tremendous. We believe the combination could have a serious adverse effect on the capital-raising capabilities of Corporate America and on the interests of some 30 million individual American investors. We believe that without modifications proposed by Senator Williams in a second bill -- which is known simply as S.3126 -- the securities auction market system as we know it today could be quickly dismembered. And this would have a potentially devastating impact on public investor confidence and on the ability of corporations to tap a broad base of investment capital.

Let me explain briefly.

Under the traditional system of fixed securities commission rates, stock exchange member brokers compete for public business primarily on the basis of the services they offer their customers. Elimination of fixed rates -- which, by the way, we regard as inevitable -- will introduce a new element of price competition. The economic impact of this could substantially reshape the way securities are bought and sold -- apart from any legislation.

When price competition in brokerage commissions hits the securities industry next year, virtually every firm will be re-evaluating its business -- focusing on areas of profitability and eliminating marginal activities and services. For many firms, this will be a matter of survival. One obvious route for many firms will be to make markets -- in their own offices -- in active stocks traded on the exchanges. With brokerage commissions on exchange business subject to price competition, firms will move increasingly to more profitable activity as dealers -- buying and selling directly to customers from their own inventories -- rather than as agents taking customers' orders in those stocks to the exchanges. By acting as dealers outside the exchanges, they can avoid much of the regulation, obligations and costs imposed on member firms.

Obviously, any movement in force away from the exchanges will diminish the importance of the exchanges. But this is by no means the basic problem. If it were, I frankly would not expect the larger corporate community to be terribly concerned.

The Biggest Losers

What should concern you is that the departing brokers will automatically take with them a substantial part of the order flow in listed stocks -- some 125,000 orders a day by the most recent estimates -- which is really what makes the stock exchanges work. And if that happens, the biggest losers are going to be the corporations and their millions of stockholders.

Consider the implications:

This vast flow of orders is the unique representation of supply and demand that today sets the prices of listed corporate stocks -- based on the judgments of thousands of investors, large and small, interacting at one place and at one time. In dealer markets, by contrast, prices are set by the dealers' individual assessments of supply and demand and, sometimes, by the state of their inventories in particular stocks.

Moreover, in dealer markets, prices will not be equally available to all investors. There may be one price for individuals and another for institutions and other large customers. When a dealer wants to liquidate his inventory in a stock, for example, he will go directly to the big buyers, with discounts not available to individuals.

What kind of continuity can be expected in dealer markets where individual dealers -- unlike exchange specialists -- can simply turn their backs and stop dealing when the going gets rough in a particular stock? A close look at the over-the-counter markets for unlisted securities in today's uncertain economic climate reveals that there simply are no real markets in many of those stocks. Dealers come and go as prices rise and fall.

Faced with this kind of unequal competition from large independent dealers who are also siphoning off the order flow in their most active stocks, specialists will have compelling reasons to set up dealer operations of their own away from the exchanges. And as this trend grows, who will make auction markets in the hundreds of less active listed stocks?

Finally, the concentration of orders on the exchanges is a major factor in making continuous surveillance and regulation of trading possible Regulating a sprawling dealer market would be vastly complicated not only by the physical dispersion of the markets, but by prices, market depth and liquidity that vary substantially from one independent market-maker to the next.

The Prospects for Individuals

The prospects for individuals aren't much brighter.

In the past, many of the companies represented here today have been very successful in obtaining the use of large amounts of investment capital from the American people. You know that investors will put their capital at risk in your companies because they have, for one reason or another, confidence in your corporate management and policies, and because they hope to share in your companies' success.

But there is a much broader element of confidence involved when millions of individuals channel part of their savings into equity investments. That element of investor confidence is firmly grounded in the awareness that the existing securities market system in this country -- whatever its imperfections -- works for them.

They know that the system as it presently operates -- the securities auction market system -- is centered in a marketplace where they can buy and sell the stocks of listed companies, at fair prices at all times.

The two-way auction process -- made up of bids to buy and offers to sell -- provides both the buyer and the seller with the best price available at a given moment. The stock prices generated in this auction process give investors and corporate issuers alike a continuous, accurate overview of what the public thinks those stocks are worth.

But faced with impaired price continuity and liquidity in the auction markets, the individual investor might turn to the dealers -- only to find that the dealers prefer to cater to large institutional customers and will only offer prices to individuals on a take-it-or-leave-it basis that bears little relationship to actual supply and demand.

Widespread uncertainty and dissatisfaction with this type of treatment -- and the absence of a satisfactory alternative -- could lead millions of individuals straight out of the market. And companies seeking to raise badly needed venture capital through new equity issues would find themselves effectively cut off from an important source of investment funds. But that's not all.

Many corporate executives tend to overlook the mutually beneficial relationship between a high level of individual public participation in the market and a corporation's ability to finance its own growth. There is a widespread belief that the most important element in corporate financing is retained earnings. And, indeed, last year, U.S. corporations plowed back some 60 per cent of earnings into new plant and equipment, research and development and all of the increasingly costly improvements which help determine corporate excellence and corporate competitiveness.

But many corporate executives, it seems to me, make the mistake of assuming that a profitable operation guarantees the ability to reinvest a high proportion of earnings. The fact is that retained earnings are available to many profitable corporations largely because stockholders are willing to forego immediate high dividend payouts in return for the prospect of higher stock values over a longer period.

In effect, corporations can retain earnings because their stockholders allow them to retain earnings. If individuals find it increasingly unattractive to participate in the market, the emphasis in individual investment could readily shift from the owners' expectation of capital gains to a European-style demand for a much larger share of earnings in the form of dividends. Obviously, if this happens on any substantial scale -- and the signs all point that way -- corporate issuers will be forced to shoulder much heavier burdens of external financing.

The net result, all along the line, would be to force corporations to rely more and more heavily on large institutions for essential capital.

A Staggering Economic Challenge

As the ranking financial executives of your corporations, you ladies and gentlemen are certainly aware of widespread serious concern today about future capital availability. According to one recent estimate, the capital needs of Corporate America, between now and 1985, will reach an astounding $3.3 trillion. And I believe that estimate was made without full reference to the capital impact of the current energy situation

At the New York Stock Exchange, rather than rely on other people's best guesses, we have launched an extensive study of the capital supply and demand prospects between now and 1985. Our objective is to obtain as accurate a picture as we can of just how much investment capital industry will need -- and where it is likely to come from.

However, there is no doubt in anyone's mind today that Corporate America is facing a staggering economic challenge. We are a nation with an expanding work force, long-standing traditions of rising wages and a rising standard of living, and a strong commitment to the greatest possible degree of economic self-sufficiency. Enormous sums of investment capital will be required to finance growth, to correct the scarcities of basic materials that are leaving great gaps in our industrial capabilities, and to maintain a competitive international economic posture in the decade ahead. The corporate community is also expected to assume a constructive role in alleviating the nation's economic and social ills -- in helping to surmount the energy problems; in overcoming commodity shortages; in beating back inflation; in halting environmental deterioration.

Corporate America can meet all these challenges -- provided, and it's a very big "if," you can raise the necessary capital.

We are talking here about multiple trillions of dollars -- amounts that would have been scoffed at, just a few years ago, as impossible.

But where is the money going to come from?

Some of our most widely respected economists and business leaders have pointed out that Corporate America is already heavily in debt, and there are limits -- in terms of conventional debt-to-equity and interest-to-earnings ratios -- to how much more can be borrowed. Add to the prospect of lower borrowing capacities the well-documented fact that inflation is severely compressing the purchasing power of corporate retained earnings, and it is apparent that those pools of capital are in danger of stagnating. Unless the equity markets can fill the ever-widening gap between capital demand and capital supply, the current murmurs about a capital shortfall may reach a thunderous crescendo that could reverberate throughout the national economy and, indeed, around the world.

The critical question, therefore, is not whether a changeover to competitive commission rates will help one brokerage firm to prosper or cause another to go out of business -- although, obviously, those are matters of vital interest to the firms involved. The really critical question is whether or not the securities industry over-all is going to be healthy enough to play a key role in helping Corporate America raise the vast amounts of capital needed to maintain and accelerate our national economic progress.

The Key Factor: 30 Million Individuals

As the capital markets in this country are currently structured, the equity capital needs of Corporate America cannot possibly be met without the active participation of millions of individual investors -- and a further broadening of the base of corporate ownership. And unless the equity markets are able to operate along lines that will actively encourage, rather than discourage, individual participation, the approach to a national securities market system could be blocked by barriers that will make it difficult -- perhaps impossible -- to achieve the desirable goals identified by Congress.

The New York Stock Exchange's Board of Directors developed, more than a year ago, a very simple solution aimed at providing an investment environment that will be hospitable to more than 30 million American investors. That solution would also help to preserve a constant flow of some 125,000 orders a day to the auction markets and short-circuit the proliferation of hundreds of independent dealer markets of varying quality, depth and regulation in listed stocks.

The Board called for legislation requiring, concurrently with a changeover to fully competitive securities commission rates, that all trades of listed securities take place on registered national securities exchanges.

This proposal would do no more and no less than require securities brokers and dealers alike -- whether exchange members or not -- to bring their trades in listed stocks to a stock exchange. This would assure that all orders of public investors in listed stocks would be exposed to all other orders of public investors in those stocks -- regardless of whether the investors happen to be private citizens of modest means or multibillion-dollar institutions. This is what happens today in a public exchange auction market. It is what does not happen in the over-the-counter market in listed stocks -- in the so-called third market. Those trades take place outside the mainstream of public orders -- and the public is denied the opportunity to participate in them.

The Fail-Safe Proposal

The Congressional leaders most actively concerned with securities industry matters clearly want to enact sound legislation that will not inadvertently produce harmful effects. This is evident in the supplementary national market system legislation -- the second Williams Bill, S.3126 -- to which I referred earlier.

This bill provides what Senator Williams and others have described as a "fail-safe" mechanism, by giving the SEC authority to require that all trades by broker-dealers in listed securities be effected on registered national stock exchanges -- if the SEC finds that the fairness and orderliness of the public auction markets have been -- or are likely to be -- impaired, in terms of the public interest.

As we pointed out to the Senate Securities Subcommittee at public hearings last Thursday, this fail-safe device does not provide the certainty that remedial action will be taken before some damage is done to the market. But without it, we would be propelled headlong into a fail-certain situation -- and we strongly supported the bill.

A Pro-Dealer-Market Coalition

At last week's hearings, spokesmen for both the SEC and the Treasury Department appeared to acknowledge the desirability of creating a safety valve, but recommended changes which, we believe, would seriously weaken the firm mandate for action provided in Senator Williams' bill. A far more hostile attitude was expressed by a coalition of third market dealers and large institutions who flatly opposed the fail-safe concept and rejected the idea that private dealer markets might not be in the public interest.

Another participant in those hearings was Cornelius W. Owens, Executive Vice President of American Telephone and Telegraph Company and one of 10 non-securities industry Directors of the New York Stock Exchange. Mr. Owens also referred to the repeated warnings that a changeover to fully competitive commission rates could, in the absence of appropriate safeguards, trigger a chain of events that would have a devastating effect on the securities auction markets and on over-all public confidence in the stock market.

He added that he, personally, found those warnings "all too persuasive -- especially with regard to the likelihood that individual investors will desert the market and that corporations will face the very real threat of institutional domination."

And that's where the matter stands today.

Congress must now decide on the essential public interest. It must answer the question of whether the essential public interest is in assuring an adequate flow of investment capital to the U.S. economy -- or, if I may paraphrase a famous controversial statement of some years ago, whether what's good for the big institutional investor is good for the country.

The Securities Subcommittee, chaired by Senator Williams, will be weighing the testimony presented at last week's hearings. Presumably, the Subcommittee will report the bill to its parent Committee on Banking, Housing and Urban Affairs,which is under the chairmanship of Senator John J. Sparkman of Alabama -- either in substantially its present, fail-safe form, or in a watered-down version reflecting the demands of the pro-dealer-market coalition. The Banking Committee will then review the bill before deciding the form in which it will be submitted to the full Senate for a vote.

It seems to me that every corporation with stock listed on a stock exchange has a vital interest in that decision. And I urge you, in the interests of your companies, your employees, your shareholders, and other investors who may wish to invest in your corporate stock in the future, to let Senator Sparkman, Senator Williams, Representative Moss and the other members of their Congressional Committees know where your companies stand on this legislation.

I don't think you can afford to remain silent or neutral.

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