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SECURITIES MARKET REFORM: A TIME TO PAUSE

Remarks by James J. Needham
Chairman, New York Stock Exchange, Inc.
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When I began preparing my remarks for this evening, the idea of an Executive Update set me thinking about the most significant things that have been happening in the securities industry. And I was somewhat surprised to realize that the most significant developments are by no means limited to the thorny policy issues that have been keeping industry executives and government regulators awake nights.

Indeed, the widely publicized passage of new securities legislation, changes in the commission-rate structure, and recent regulatory developments seem to have diverted attention from the fundamental functions and purposes of the securities industry in the United States. And I cannot help wondering whether, in the general eagerness for change, some people -- both in Wall Street and in in Washington -- have lost sight of the basic reasons why some things need to be improved.

To put it somewhat more bluntly, I wonder whether we are in danger of "improving" the market so much that, in the future, only the most sophisticated professional investors will be able to use it. And if so, is that really what we want to do?

Since the beginning of the year, of course, record-shattering volume in the stock market has pre-empted most of the headlines. And rightly so. Last month was, by far, the most active month in the history of the New York Stock Exchange. Eight of the 10 busiest days on record occurred during January, and more than 635 million shares of stock changed hands on the Exchange.

Many of you will recall the dramatic upsurge of volume back in 1967 and 1968 -- when an unprecedented flood of stock transactions came close to overwhelming Wall Street. At the peak of what was rather ingenuously called The Paperwork "Problem" -- in December 1968 -- daily volume on the New York Stock Exchange averaged an astounding 15 million or so shares. By contrast, volume last month averaged more than 30 million shares a day -- and the only current talk about a paperwork problem seems to be a perversely almost-affectionate recollection of survival eight years ago.

WHERE IS THE LITTLE GUY?

However, the relative absence of substantial increases in odd-lot and other orders of less than 200 shares strongly suggests that the investor of modest means has not yet overcome the disenchantment that led millions of so-called "little guys" to withdraw from the market during the early 1970s.

As some of you may be aware, the New York Stock Exchange's recently published 1975 "Census of Shareowners" estimated that the number of U.S. holders of corporate stocks and mutual funds diminished by some 5½ million individuals between early 1970 and mid-1975 -- from 30.8 million to 25.2 million.

Disheartening as that fact may be, no one in Wall Street was really caught by surprise. Without trying to apportion blame for the exodus of so-called "small" investors from the market, several reasonable observations can be made.

I recall that, back in late 1967, when the early signs of the paperwork problem began emerging, one commentator suggested, rather inelegantly, that Wall Street had been caught with its pants down. What he meant, very simply, was that the brokerage community was unprepared to handle the incredible continuing deluge of orders.

For investors who lost money during the long, industry-wide financial crisis and market decline that followed on the heels of the paperwork disaster, bad memories have understandably lingered.

Just last year, when heavy trading activity in the early months pre-figured the current upturn, the mini-bull market slipped by almost unnoticed -- largely, I believe, because the concerns of the general public were strongly focused on the pervasive problems of national inflation and recession. At that time, few individual investors found convincing reasons for coming back into the investment mainstream.

But with economists now offering more optimistic views of the future, and with the "big guys" clearly demonstrating renewed confidence in the market, some prognosticators seem to think the "little guys" may be getting ready to come back in.

And a big part of our job at the New York Stock Exchange is to try to see to it that -- if that does happen -- the securities industry, or at least the part of the industry represented by our member firms, gets caught with its pants up. Much of our work over the past five years has focused on trying to assure that whatever an investor decides to do with his funds, the industry will be able to handle his business speedily, efficiently, and without financial risks that are unrelated to the actual performance of the market.

FINANCIAL PROTECTION FOR CUSTOMERS

One key area of improvement has focused on bolstering the financial capability of New York Stock Exchange member firms. This has involved both broadening the sources of capital they can draw upon for their own businesses, and strengthening the Exchange's continuing program of monitoring the firms' compliance with stringent new capital requirements. These measures have helped make it unlikely that -- short of a national economic collapse -- we will ever experience a re-run of the 1970 securities industry financial crisis.

Moreover, there is now the Securities Industry Protection Corporation -- a Federal agency created by Congress, with the support of the industry and funded by assessments on the industry -- to oversee the orderly liquidation of any securities firm that does encounter severe financial problems. It is worth noting that, in the first five years of its existence, that agency -- SIPC -- has assisted in settling the claims of customers of 117 securities firms in liquidation, only one of which was a New York Stock Exchange member.

A COMPUTERIZED SECURITIES INDUSTRY

A decade ago, the securities industry -- with some exceptions, to be sure -- seemed to regard computers and all the other complex paraphernalia of automation as exotic, intimidating gadgets that perhaps the next generation of brokers might be able to understand and operate. Well, for all practical purposes, that next generation of brokers has already matured and is running the industry. Precise statistics are hard to come by in this area, but we know what the Exchange's own automation expenses have been -- and I would hazard a guess that the securities industry over-all has been pouring upwards of $150 million a year into developing and maintaining its automation capabilities. At the Exchange, the powerful forces of automation have been harnessed to data-processing and to what we call the after-trade processes -- that is, the clearance and settlement of transactions and the transfer of securities ownership.

To cite just one of the key developments, today's nationwide network of securities depositories, of which the Exchange-developed

Depository Trust Company is the nucleus, has virtually eliminated the stock certificate as a significant element of the trading process. Securities ownership today is transferred almost entirely by computerized bookkeeping entries, without physical transfer of certificates among brokers and their customers.

AUTOMATION IN THE MARKETPLACE

Automation in the marketplace itself is also producing some spectacular results. We now have a consolidated ticker tape that reports, in sequence, all transactions in New York Stock Exchange listed stocks, wherever they take place -- on the NYSE, or on a regional stock exchange where the stocks may also be listed, or over the counter. This means it is now possible, for the first time, to know exactly how many transactions -- of what size and at what prices -- take place in any listed stock on any trading day.

Possibly the most exciting innovation of all is scheduled to go into service on the Exchange trading floor next month. This is something we call the Designated Order Turnaround System -- which is quite a mouthful, so we have begun identifying it by the acronym, DOT. And it is about as close to magic as stock market automation has yet come in improving service to investors who trade in smaller amounts of stock.

Very briefly, when a customer gives a member broker an order to buy 100 shares of a listed stock at the prevailing market price, the broker will enter that order into his firm's computer, which will transmit it to a Common Message Switch at the Exchange. The Exchange computer will translate the order into a standardized format -- a kind of NYSE Esperanto that is necessary because the computers at different firms speak different languages. The translated message will then be transmitted automatically to a printer at the trading post on the Exchange floor where that stock is traded. The order's travel time -- from member firm computer, through the Common Message Switch, to the post -- is four seconds. The Exchange stock specialist, receiving the order at his post, will represent it in the auction trading crowd, where the price is competitively determined with brokers representing orders from other customers. Once the transaction is completed, the specialist's clerk will make a few pencil strokes on a special card and drop the card into another terminal for its near-instantaneous trip back to the member firm computer. The broker will receive, in his office, a complete recap of the order and transaction -- translated back into his own computer's language.

Initially, the DOT system will handle only 100-share market orders which, by themselves, account for nearly 20 per cent of the total order flow to the Exchange trading floor. But its potential is staggering. Later in the year, we expect to add in larger market orders and limit orders -- that is, orders for which the customer specifies the price he is willing to pay or accept -- and full reports on all transactions in which a broker on the trading floor has acted as a customer's agent.

COMPETITION ON THE TRADING FLOOR

While many of the most spectacular Wall Street innovations involve automation -- a great many other changes are under way at the New York Stock Exchange. And I would like to touch on just a few of the most important ones.

Many of our current efforts focus on measures to improve competition in the market in ways that will benefit the investing public. Last week, the Exchange's Board of Directors received a comprehensive report from a special committee that has conducted an intensive study of the allocation of stocks to specialists on the Exchange trading floor. That committee, chaired by William M. Batten, former Chairman of J.C. Penney Company, and a Public Director of the Exchange, recommended major procedural changes aimed at improving the quality of the markets maintained by Exchange specialists in the stocks of the more than 1550 corporations listed on the NYSE.

On the basis of extensive fact and opinion-gathering carried out with the assistance of two leading outside consultants, the committee concluded that the Exchange's continuous two-way auction market system offers the fairest and most effective means of pricing stocks. They concluded, too, that the specialist is essential to the operation of that system.

Less flatteringly, however, the committee suggested that there is plenty of room for improvement -- particularly in the method of assigning stocks to individual specialist units and in judging how effectively specialists are carrying out their market-making responsibilities. The committee called for intensified evaluation of specialists' performance, a new, competitively oriented procedure for allocating and reallocating stocks to specialist units, and better ways of keeping the public informed about matters relating to the trading floor.

To accomplish these goals, the Batten Committee proposed restructuring key parts of the Exchange's self-regulatory apparatus to reduce the participation of specialists themselves in the stock allocation process and to provide more direct supervision by the Board of Directors.

The Board itself was strongly impressed by the Batten Committee's report and recommendations -- and the initial reaction from our membership and from outside the Exchange has been very favorable. There seems little doubt that the Board will move as quickly as possible to implement them.

AN INTERNATIONAL MARKETPLACE

In a totally different area, our Board is now studying a number of recommendations proposed by the Exchange's Advisory Committee on International Capital Markets, which is headed by Robert V. Roosa, former Undersecretary of the Treasury for Monetary Affairs. The thrust of these recommendations is that the Exchange should facilitate listing the stocks of large foreign corporations by adopting certain alternate listing standards. These standards would apply where the distribution and value of shares now held publicly in this country are insufficient to enable such internationally active and successful companies as British American Tobacco, Fiat and Mitsubishi -- to name just three of many -- to qualify for listing. The proposals would permit a foreign corporate listing applicant to qualify on the basis of very substantial worldwide share distribution, earnings and net tangible assets, provided the company can also meet prevailing Exchange requirements with respect to corporate disclosure, financial reporting and other standards designed for the protection of shareholders.

I personally feel very strongly that adoption of the Advisory Committee's recommendations would go a long way toward expanding the New York Stock Exchange from a primarily domestic market to a genuinely international market, an objective sought by the Exchange for many, many years. And I believe the Advisory Committee is to be commended for developing a means of accomplishing this -- and of broadening the investment opportunities available to U.S. investors -- without in any way disadvantaging domestic corporations seeking to list their shares in our market.

THE INTENT OF CONGRESS

At the beginning of this talk, I wondered out loud about the ultimate beneficiaries of the past half-decade of dramatic changes in the securities industry. Many of the initial changes were dictated by the industry's and government's realization that the traumatic occurrences of 1968, 1969 and 1970 must never be repeated. By and large, the victims of that period -- if that is not too strong a word to use -- were brokerage firms and their smaller customers.

Logically, then, the changes should be -- and many of them have been -- designed to strengthen customer protection and to rekindle public confidence in the operation of the securities markets in this country.

Beginning in 1971, Congress, acting from the highest motives, worked long and hard to fashion important new securities legislation. In the legislation enacted last June, Congress charged the Securities and Exchange Commission with seeing that the intent of Congress is carried out. And the Commission has already taken a number of important steps in connection with that mandate.

On the face of it, all is as it should be. And yet, in fact, all is far from being as it should be. Somewhere along the way, the intent of Congress to strengthen the capabilities and service potential of the U.S. securities industry seems to have given way to a concept of change merely for the sake of change. And I cannot help wondering whether Congress really intended some of the things we are seeing.

For example, there is the question of commission rates. Congress left little doubt that it intended to do away with fixed minimum charges for brokerage services, in favor of so-called "competitive" commission rates. The result has been a very serious price war among securities firms -- a price war in which the big winners are institutional investors who, neither surprisingly nor improperly, are using their immense power as major customers to force rates down. The individual investor, however, lacking that kind of clout, is paying substantially the same rates he paid before to have his transactions executed. Is that kind of price discrimination what Congress really intended? I wonder.

The emphasis on "competition" has extended to measures aimed at stimulating competitive market-making in listed stocks. Recent actions by the SEC represent a first step toward throwing such market-making activities open to almost anyone who wants to get into the act. Here, too, the large institutions have the resources and expertise needed to look after their own best interests.

According to the schedule indicated by the SEC, however, the individual investor will soon be partially -- and then fully -- deprived of the protections now available through Exchange regulation of its own members' conduct -- unless new regulatory safeguards, yet to be developed, are instituted.

AN ENORMOUS QUESTION-MARK

Finally, there is the enormous question-mark known as a Central or National Market System. The Congress has espoused the concept of a National Market System and, in effect, told the SEC to see to it that it comes into existence as quickly as possible. And the SEC, in turn, is prodding the securities industry to act.

Now, the SEC is probably one of the most effective and most competently staffed and managed of all government agencies. Since Congress offered no precise definition of a National Market System, it directed the SEC to create a top-level National Market Advisory Board to assist in determining how the system should be structured and how it should function.

However, the complexities involved in developing a national system make a difficult assignment next to impossible for a group representing the spectrum of differing viewpoints -- however dedicated and however expert -- to come up with all the details of a workable system. The New York Stock Exchange's own Central Market System Committee is pressing forward to formulate guidelines for developing such a system, and its recommendations will be presented to the Commission's Advisory Committee.

The task is to fit all the pieces together to form a smoothly operating market mechanism that will be better than what it replaces. Assuming this can be done, it will not be easy. It will require time and money. Not the least of the effort ahead will involve trying to accommodate everyone's pet theories and concepts to what is realistically possible -- if we are indeed to fashion a new market structure and regulatory superstructure that will better serve the national economic interest.

A TIME TO PAUSE

Before we rush forward to implement grandiose plans to build a new structure, I believe it is both prudent and necessary to pause and re-examine the question of just what we are trying to achieve. What is the objective of a Central Market System? Who is it to serve? How will it be better than the present system -- a system that is internationally acknowledged to be by far the strongest in the world?

Perhaps the most pertinent question of all is: Do we not already have a Central Market System -- a system firmly anchored in the New York and American Stock Exchanges, with a satellite network of regional exchanges and over-the-counter dealers all trading the same relatively few listed stocks?

Let's look at some of the facts. About 85 per cent of the volume in New York Stock Exchange listed stocks flows to the central marketplace that is the New York Stock Exchange. This business is directed to the Exchange by the customers and brokers initiating the orders for them because the Exchange provides the best market. The flow of orders and transactions, in turn, creates the most sensitive pricing mechanism for stocks, assuring that price changes from one transaction to the next reflect the full interplay of supply and demand at any given moment. And it is the NYSE pricing mechanism that makes it possible for the other securities markets to function.

This fact was demonstrated again just eight days ago when the Monday morning storm conditions in the New York area forced the New York Stock Exchange to delay its opening from 10 a.m. to 11:15. During the 75 minutes when the NYSE pricing mechanism was not functioning, a total of 55 transactions -- not 55,000, but 55 -- took place in all other markets, with fewer than 31,000 shares changing hands. Many of the other markets simply remained closed -- until we opened and they had the benefit of the pricing mechanism in New York.

It seems clear to me, therefore, that there is indeed a Central Market System in operation in this country today.

Is it nonetheless necessary to replace the existing pricing mechanism with "something else" that will put everyone -- Exchange members and non-members alike -- on a lesser footing? How will that affect the pricing of securities? Will a weaker pricing mechanism mean less than optimum buying and selling opportunities for investors? Will individual investors be particularly disadvantaged?

In the months ahead, these and other pertinent questions will have to be answered. And these questions will lead to even more fundamental ones -- such as, what kind of national economic system is likely to evolve in this country in the absence of widespread public participation in the ownership of American business? The consequences of telling millions of Americans who have traditionally supported the principles of private enterprise capitalism in the United States that they are no longer welcome to participate in a government-mandated securities market system may have to be explored.

I personally believe that the Central Market System of the future will prove to be very much like the Central Market System of the present. I believe that, because I believe the people who will be responsible for the crucial decisions will refuse to turn their backs on the American investing public.

Only time will tell whether I am right.

The story of what happens over the next few years may offer a very provocative subject for a future Fairleigh Dickinson Executive Update -- from the New York Stock Exchange.

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