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ELECTRONIC LINKAGE: A TRANSCONTINENTAL HANDSHAKE

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I want to discuss an aspect of the stock market this evening that almost everyone knows something about - - but that almost everyone also has some misconceptions about. And that is the National Market System for securities that people assume is going to join, assimilate or replace all of the existing marketplaces in which the nation's leading corporate stocks are now traded.

One question I encounter fairly frequently - - and from some quite sophisticated people - - is: Why does the Exchange want to make drastic changes in a system that works so well? And sometimes before I can reply, someone else will answer: They don't want to - - they're being forced to.

The answer really lies somewhere in-between. We do think it is possible to improve on the existing combination of auction and dealer markets in listed stocks - - and we want to do that. It is also true that Congress enacted legislation calling for a new market structure - - so we would be required to make changes even if we didn't want to.

At the same time, we believe it would be irresponsible to dismantle the existing structure, as some have suggested. We believe, rather, that a new National Market System should evolve and build on the strengths of the present system - - and that is what we are trying to set in motion.

Discussion of a National Market System has been clouded by so many misperceptions, so much confusion and misunderstanding and, in some quarters, reactions so nearly approaching panic, that we need to revisit the basic concept and strip away the fantasies and folderol that have accumulated around it since Congress first set the stage for its evolution.

I believe this is particularly relevant for key executives of publicly held corporations - - because it is your companies' stocks that will be traded in any new systems.

Much of the confusion to date has stemmed from the enthusiastic efforts of interested parties, both within and outside the securities industry, to explain what Congress intended - - efforts which, logically, might be better left to Congress itself.

In any case, what Congress <u>said</u>, in the Securities Acts Amendments of 1975, is - - and I am quoting now:

"The securities markets are an important national asset which must be preserved and strengthened."

Congress also said - - and I am quoting again:

"New data processing and communications techniques create the opportunity for more efficient and effective market operations."

THE LINKING OF ALL MARKETS

Congress concluded - - and this is a third direct quote:

"The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders."

It is very pertinent to note that Congress referred specifically to "the linking of all markets" - - not to the amalgamation of all markets, nor to the homogenization of all markets, nor to the elimination or replacement of all markets.

Finally, Congress directed the Securities and Exchange Commission to "facilitate the establishment of a National Market System" and "to authorize or require self-regulatory organizations to act jointly. . . in planning, developing, operating or regulating a National Market System."

Congress also made clear that the governing principles set forth in the basic Federal securities laws should apply to the development of a National Market System. That is, whatever is done must be consistent with the public interest, the protection of investors and the maintenance of fair and orderly markets for corporate securities.

Congress, in its wisdom - - and I use that word advisedly - - did not attempt to describe a National Market System or to depict the elements which, in the aggregate, would transform the concept into a fully functioning system.

However, the House Committee on Interstate and Foreign Commerce, which played a key role in shaping the 1975 securities legislation, observed - - and this will be the last Congressional quote for a while:

"Neither the markets themselves nor the broker-dealer participants in those markets should be forced into a single mold. Market centers should compete and evolve according to their own natural genius."

It is fair to ask, in view of the guidelines provided by Congress, why, more than two years after the enactment of legislation calling for the development of a National Market System, the securities industry is not closer than it is to putting the system into operation.

Some observers have accused the industry of dragging its feet. Others have suggested that a lack of leadership - - either within the industry or in Washington - - has hindered progress.

I don't believe either of those assertions provides the real answer. The fact is that while the National Market System concept has been almost universally accepted and endorsed, the task of translating the concept into a blueprint for a system that will actually work defied, until fairly recently, the very best minds in the business.

One problem, I believe, is that while some of us in the industry have assumed that Congress both knew what it was saying and meant what it said, others have ignored that direction - - intentionally or otherwise - - and offered proposals for a National Market System that would produce results directly opposed to what Congress called for. Not surprisingly, those proposals have triggered a good deal of controversy and deflected much of the industry from the business at hand. But we think we are finally on the right track.

One key stumbling block has been the need to devise a viable means of getting from where we are today to where we all want to be - - of working out a plan of transition or evolution from the present highly effective securities market system to the desired new system, without either compromising the Congressional guidelines or disrupting the operation of the nation's capital markets.

This involves so many complex technological details, so many divergent, legitimate economic interests, so many prospective pitfalls and - - to put it quite bluntly - - the commitment of so much effort and money, that the only possible approach is through a coordinated, industry-wide effort to build a sound new superstructure on the strongest foundations of the existing exchange auction market system. And that effort is now underway.

At the New York Stock Exchange, we do not know precisely what the National Market System will look like five or ten years from now - - no one does - - but we believe we have found a sensible approach to developing it.

A MODEL STRUCTURE

At public hearings conducted by the SEC in August, we presented a fairly detailed model of a National Market System structure that would, in fact, link the markets through new communications and data processing techniques - - as Congress specified - - and, thereby, pursue the goals outlined in the 1975 legislation.

The structure we proposed requires five key elements, one of which - - the Consolidated Tape for reporting trades in all eligible securities - - is already in place and operating smoothly. The other four elements are:

First, a Composite Quotation System for displaying both bid and asked quotations in all reported stocks - - and, ideally, the number of shares bid for and offered at the quoted prices.

Second, a system of Equal Rules and Regulations applying to all qualified market-makers within the system, with a provision allowing each market center to establish higher - - but not lower - - standards within its own market.

Third, appropriate Trading Surveillance Requirements, to be established and monitored by each market center.

And, finally, an electronic linkage among all the competing market centers that will assure the all-important interaction among orders in reported stocks. This is the key element in the structure since, as you will recall, Congress specifically called for "the linking of all markets for qualified securities through communication and data processing facilities."

The linkage we envision will permit investors' orders to meet and be executed without the intervention of a dealer, whenever that is possible. It will also maximize competition among market-makers to narrow price spreads and give any customer the benefit of the best quotation anywhere in the system when there is no other offsetting customer interest.

PROGRESS TOWARD AN INTERMARKET TRADING SYSTEM

We have begun working on the kind of electronic linkage - - which we call the Intermarket Trading System - - that will take full advantage of the ability of computers to communicate market information and to follow the explicit commands of human decision-makers in pricing and trading corporate stocks.

We have entered into agreements with the Pacific and Philadelphia Stock Exchanges which - - subject to ratification by our respective governing boards - - should speed this important step toward establishing a full National Market System. We have made it clear that all other securities industry self-regulatory organizations are welcome to participate in the Intermarket Trading System - - including the other registered national securities exchanges and the National Association of Securities Dealers, which governs over-the-counter trading in the stocks that will be traded through the linkage.

And I am told that a decision on participation in the system may be taken by the Board of the Boston Stock Exchange at its meeting next week. An affirmative decision would, of course, enhance the nationwide scope and character of the system.

The basic idea of the Intermarket Trading System is simplicity itself. Essentially, it will be possible for a broker or market-maker who is physically present in one marketplace to electronically represent his own or his customers' orders in other marketplaces that are hundreds or thousands of miles away - - enabling those orders to interact with orders held by brokers and market-makers who are physically present in the other marketplaces. Obviously, this will strengthen competition nationwide and increase the potential for buyers and sellers of eligible stocks to obtain better prices than might otherwise have been available to them.

The linkage consists essentially of a network of interconnected terminal devices in the participating market centers. These units will enable brokers and market-makers in each market center to make specific commitments to their counterparts in other market centers to buy and sell eligible stocks, and to transmit confirmations of trades and transaction reports.

A key adjunct to the linkage will be quotation displays in each participating market center that will show, in addition to the current quote for each eligible stock in that market center, either the current quotes in all other participating market centers or the best quote available systemwide.

HOW THE LINKAGE WORKS

Perhaps the best way to explain how all this will work is to figuratively walk a simple order through the system.

Let us assume that a broker on the Pacific Stock Exchange has a market order to sell 100 shares of XYZ stock. The quotation display on the trading floor in San Francisco shows that the best current bid for XYZ has been entered on the New York Stock Exchange, and he decides to request a trade there.

He enters a commitment - - a firm commitment - - into the CRT terminal in San Francisco to sell 100 shares at the bid in New York. Within seconds, that commitment is both flashed on the CRT screen and printed out at the specialist's post on the New York Stock Exchange trading floor, where it can be exposed to the auction crowd or executed against the specialist's book - - as circumstances may warrant.

If the Pacific Stock Exchange broker's commitment is accepted, a message to that effect is flashed back - - again, in a matter of seconds - - to the CRT screen in San Francisco, and an immediate confirmation is printed out there.

This is the equivalent of the traditional brokers' handshake - - signifying that a transaction has taken place - - stretching clear across the continent.

Once the trade is consummated, it is immediately reported to the consolidated tape, and the normal clearance, settlement and transfer procedures are initiated by the market center in which the trade occurred - - in this example, by the NYSE. The system itself, of course, maintains a complete record of all transactions executed, and all communications passing through, its facilities.

THE CRUCIAL ADJUNCT: UP-TO-DATE, FIRM QUOTES

Obviously, the ready availability of up-to-date, firm quotes is crucial to the effectiveness of the trading linkage. Accordingly, a key condition of participation in the Intermarket Trading System is that each market center must agree to provide all other participating market centers with up-to-date, firm quotes for 100 shares or more in all of its eligible stocks, and to display within its own market at least the best systemwide quote in each stock traded there. In addition, the participants have agreed to exchange pre-opening information in all eligible stocks before the start of trading each day.

From a practical standpoint, perhaps the most important advantage of the Intermarket Trading System - - and its quotation network adjunct - - is that it can be brought into operation very quickly and relatively inexpensively. It will also give all participants very valuable practical experience in dealing with intermarket quotations.

What kind of time-frame are we talking about? Our agreements with the Pacific and Philadelphia Stock Exchanges - - and with Boston, too, if that exchange decides to participate - - look to putting a pilot system into operation by late March or early April - - and to expanding the operation to include many of the most competitively traded stocks by next fall. It goes without saying that we will be monitoring and evaluating each phase of the operation - - and improving or modifying it, as necessary - - before moving on to the next.

We think this is a realistic, prudent approach to assuring that there will continue to be a strong national securities trading environment and to preparing the way for a smooth transition to the National Market System of the future.

A HOST OF PRACTICAL ADVANTAGES

In addition to being entirely consistent with the conceptual requirements proposed by Congress, the Intermarket Trading System offers many specific practical advantages to all securities industry constituents who have an important stake in maximizing the effectiveness of the securities markets.

One of the most important advantages of the system is that it preserves the key element of human judgment in pricing and trading corporate stocks - - while employing advanced technology to facilitate the execution of transactions between marketplaces.

No less important, it helps solve the dilemma of how to put technology at the service of the investing public, corporate issuers and the securities industry itself, without giving computers the power to dictate how, where and by whom corporate stocks may be traded.

By enhancing market-making capabilities in all participating market centers, the system provides a positive stimulus to stronger competition among securities industry professionals for the privilege of handling public orders to buy and sell corporate stocks.

It will also help maximize the opportunity for those orders to meet and interact, coast to coast, in a highly visible setting that offers more specific protection for public limit orders than presently exists in most marketplaces. And it will concurrently assure the continuity of round-the-clock regulation and surveillance of trading activity in stocks that are traded through the linkage facilities.

In short, while the Intermarket Trading System is far from the final step in bringing a National Market System into existence, it signifies the clear commitment of the participating self-regulatory organizations to set aside the parochial considerations that may have inhibited progress in the past, and to get on with the job of complying with Federal law.

It is certainly no secret that the New York Stock Exchange potentially has more to lose than any other participant in the competitive environment of the new system since, as an executive of one of our best-known member firms has pointed out, it really gives the other exchanges a shot at the order flow in New York.

On the other hand, the people on our trading floor have been making it clear that they are not afraid to meet the competition head-on. One highly respected specialist summed up this attitude the other day. Acknowledging that the start-up of the Intermarket Trading System might very well draw some business away from the NYSE, he added: “We’re professional enough to realize that if we are good, we will get the business back.”

INPUT FOR DECISION-MAKING

Obviously, we are on the threshold of important changes in the way stocks are traded in this country. At the New York Stock Exchange, our concern is to see to it that the changes are constructive, rather than destructive. We are going to have to make a great many crucial decisions as new systems evolve and develop - - and we are going to need all the help we can get to assure that we make decisions that are right not only for us, but for our constituents, as well.

This is particularly important for the corporations whose stocks are traded in the marketplace. That marketplace is your marketplace. Changes in how it operates can have a major impact - - favorable or otherwise - - on your ability to raise urgently needed equity capital in the years ahead. To us, at the New York Stock Exchange, that means, very simply, that we must maintain a decision-making partnership with our listed companies.

We are not talking about cosmetic efforts. We are talking about direct participation in decision-making. And, in fact, listed companies have already seen how their views and concerns can be incorporated into our decisions on important issues affecting their interests.

Last year, as many of you may recall, we asked the chief executive officers of all NYSE listed companies to comment on proposals for requiring all listed companies to have audit committees of independent directors. And the hundreds of constructive responses we received helped reshape those proposals substantially before they were adopted. We also asked for listed companies' views on a proposed merger between the New York and American Stock Exchanges; and those responses, too, have helped shape Exchange decisions on the merger issue.

More recently, we made a major effort to keep all listed company chief executive officers fully informed about developments relating to a proposal by the SEC to repeal the off-board trading rules of the various stock exchanges. That issue, of course, bears directly on the ability of the securities markets to continue to meet the needs and concerns of listed corporations and their stockholders during the evolution of the National Market System.

And the CEOs of a great many listed companies across the country - - including quite a few based here in New England - - have expressed, to the SEC and, in some cases, to their U.S. Senators and Congressmen, their deep concerns about the prospective impact of that proposed action on their businesses. I should add that the concerns of the Massachusetts business community were very strongly underscored by Senator Edward W. Brooke.

And while the SEC has not yet announced a final decision, it seems clear that the concerns of corporate leaders are not being ignored in the Commission's continuing deliberations.

Our experiences to date in obtaining valuable input from our corporate constituents leave no doubt in our minds that listed companies want a role in our decision-making; that they are entitled, as the providers of the products that are traded in our marketplace, to a role in our decision-making; and that they can make very important contributions to our decision-making.

To strengthen the two-way flow of information between the Exchange and the corporate community that is so essential to informed decision-making, we have established a Listed Company Advisory Committee to our Board of Directors - - a Board that, itself, includes seven present or former chief executive or senior officers of listed companies.

The Listed Company Advisory Committee is made up of the chief executive or chief operating officers of twelve companies representing the full spectrum of the Exchange's corporate constituency - - in terms of company size, geographic location, type of industry, and so on. Headed by C. Peter McColough, Chairman of Xerox

Corporation, this committee provides a specific vehicle both to keep the corporate community informed about issues of mutual concern and to feed their views and recommendations back to us. We fully expect the Listed Company Advisory Committee to play an expanding role in helping our Board shape Exchange policy on all such issues.

I can also promise you, unequivocally, that we will be asking you directly for your views and comments on specific issues, more and more frequently in the months and years ahead - - particularly as we, at the Exchange, try to provide the kind of fully representative leadership that is essential to evolving a National Market System that will serve the legitimate needs and interests of all stock market constituents.

That system will belong to corporate America even more surely than to the securities industry - - and we believe corporate America has a clear responsibility to help assure that it will be the very best market system that time, effort, ingenuity and money can buy.