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FROM HERE TO MODERNITY

An Address By

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Securities and Exchange Commission

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SECURITIES INDUSTRY
ASSOCIATION

The Greenbrier
White Sulphur Springs, W. Va.

Last fall in Boca Raton, John Whitehead, in his address as outgoing Chairman of the Securities Industry Association, called for "a new and vigorous program to create a healthier capital markets system and a healthier securities industry." In considering means to this end, John observed that the scope and jurisdiction of the Securities and Exchange Commission and the self-regulatory bodies apparently were too narrow, since questions such as the preservation and stimulation of our capital markets had not, to that point, been adequately addressed by any of them. To fill this void John proposed "the creation of a new federal agency or public corporation" which, in substance, would have the duty to:

- (1) establish and administer standards of entry into the securities business and performance for securities firms;
- (2) develop a central market system, as well as systems for centralized securities processing and for pricing of the securities industry's services;
and
- (3) coordinate the activities of the various industry regulatory bodies to assure the efficiency of the markets and their responsiveness to the public interest.

John Whitehead was not alone in his call for a new agency. Frank Weil, Ralph Saul, Paul Kolton and others had raised similar questions, publicly or privately, and posed similar solutions.

The idea that our capital markets are a critical national resource that should be kept healthy was not a new one to us. The thought that our capital markets were threatened because of limitations in authority, resources or outlook on our part -- and that this is a deficiency so severe as to require the creation of a new agency -- was new. In considering John's proposal, however, one fact seemed paramount. Even if a new agency or public corporation should ultimately appear desirable, its appearance will not be soon. In the meantime all the securities industry has is us, and all we have, in addition to our personnel, are the present statutes that we administer. Inasmuch as, and for as long as, we are thus stuck with each other, it seemed more profitable, at this time, to work on what can be done under these conditions, rather than consume time and probably generate heat over the new agency idea.

Consequently, I cannot today give you our official view on that part of John's proposals. We haven't devoted our labors to developing such a view. We have, instead, been devoting our

thoughts to what we can do with what we have. We think we can do a lot, and that is what I want to talk about. Without suggesting any reduction in our efforts to increase investor protection through better disclosure of company information, better regulation of our existing markets and strong enforcement, we accept the proposition put to us by John and others that our oft-repeated mandate to act "in the public interest and the interest of investors" includes the preservation or restoration of a securities industry able to meet the needs of investors and the capital-raising requirements of industry. Within the limits of our authority, resources and competence, we have been struggling for ways to express this concern in a constructive manner.

In the process, we have concluded that we should, in effect, concentrate on the second of John's felt deficiencies in regulatory guidance and begin promptly concrete planning toward the development of a central market system along the lines set forth by the Commission in its so-called White Paper of March 29, 1973, and certain related policies. As all of you know who have paid attention to the many studies and debates on the various aspects of market structure during the past decade and more, the policies expressed in that White Paper were not the sudden constructs of government lawyers derived from legal theories without the benefit

of experience and reflection of persons engaged in the securities industry. Rather, these White Paper policies, and related policies adopted by us, reflected our acceptance of what we judged to be the best advice of persons who made their views known, including the conclusions and recommendations of Congressional studies and many persons with a deep experience in and knowledge of the securities industry. I am not trying to disown these policies by saying that they are really other persons' ideas but only to remind you, if this makes them more acceptable to you, that members of the industry, directly or indirectly, played a major role in their development.

The central market system as we see it contemplates the following in broad outline:

- Full and complete disclosure of transactions and quotations from all markets in listed securities.
- The elimination of barriers to access between those markets.
- Integration of all market makers into the central market system by including them in the disclosure system and subjecting them to appropriate market responsibilities commensurate with the benefits they may realize, including, but not limited to,

the obligation to contribute to the orderliness and depth of our markets.

- Identification and incorporation of the important features of auction principles.

I believe, however, that the major worries confronting the industry right now are not so much these objectives as stated -- although I recognize that they are not universally accepted -- as the fact that the statement of objectives poses many difficult questions that remain unanswered, such as:

- What should be the specific characteristics of the system and what role should each of the present participants in the market play;
- What costs are involved, and who should bear them; and
- What rules are needed and what supervising, coordinating or governing body is needed?

Recognizing that this is only a brief summary of the unresolved questions, leaving many more to be identified; recognizing that the Commission and its staff are not experienced, technical experts in many of the operational aspects of the

industry; and recognizing, further, that in any event it is desirable for persons in the industry or users of the markets and academic experts to play a strong role in working out these problems and for the Commission to have the benefit of their considered views, we decided to take now a step contemplated by our White Paper. We announced recently our intention to establish a committee to be known as the Advisory Committee on the Implementation of the Central Market System.

We have given much thought to the concept, composition and mission of this committee, much of it with the benefit of the committee's chairman, once he had agreed to serve. A committee of this nature, we concluded, should be small, but within this limitation reflect as many relevant types of experience and knowledge as possible. On the other hand, it is not intended as a deliberative or negotiating body; hence no one has been selected to represent a particular constituency, either as to type of business, self-regulatory organization or geographical region. It is intended to be a working group of indefinite duration which will advise us on a series of specific matters from time to time rather than submit one comprehensive report and disband. It is not the mission of the

committee to reexamine the fundamental postulates of the central market system, but rather help us, all of us, get from here to there.

The chairman of the committee, as we previously announced, is Alexander Yearley, IV, who is Chairman of the Board and Chief Executive Officer of the Robinson-Humphrey firm in Atlanta. Sandy has served as Chairman of the Board of Governors of the NASD, as a member of the New York Stock Exchange's Board of Governors, and was a member of the Board of Governors of the Investment Bankers Association from 1960 to 1962.

The other members of the committee are:

Kenneth S. Axelson, who is Vice President, Director of Finance and Administration, and a director of J. C. Penney Company, Inc., New York, New York. Mr. Axelson is also a CPA and was a practicing accountant prior to joining Penney's. He was a member of the Accounting Principles Board from 1968 to 1970 and currently serves as a trustee of the Financial Executives Research Foundation;

M. Colyer Crum, who is the Associate Dean for Executive Education and External Affairs and the James R. Williston Professor of Investment Management of the Harvard Business School;

Robert M. Gardiner, who is President, Director and Chairman of the Executive Committee of Reynolds Securities, Inc., New York, New York. He is a former member and officer of the Association of Stock Exchange Firms, the National Association of Securities Dealers, Inc., the National Clearing Corporation, and served as Chairman of the Board of the Securities Industry Association from 1972 to 1973. He is the current Chairman of the Securities Processing Committee;

C. Rader McCulley, who is President of First Southwest Company, Dallas, Texas. Mr. McCulley has served on committees of the National Association of Securities Dealers, Inc., and as a member of the Association's Board of Governors, and is presently a member of the Commission's Advisory Committee on a Model Compliance Program for Broker-Dealers;

Ray F. Myers, who is the Executive Vice President, Trust Department, the Continental Illinois National Bank and Trust Company of Chicago and a member of the Trust Executive Committee of the American Bankers Association;

Felix G. Rohatyn, who is a general partner of Lazard Freres & Co., New York, New York. He is a former member of the Board of Governors of the New York Stock Exchange;

Donald Stone, who is a senior partner of Lasker, Stone & Stern, New York, New York, and a member of the Automated Specialists' Book Committee of the New York Stock Exchange. Mr. Stone served on the Advisory Committee to the Commission's Institutional Investor Study and as a member of the Commission's Advisory Committee on Market Disclosure.

For staff support, Andrew P. Steffan, Director of the Office of Policy Planning of the Commission, will serve as Executive Secretary. The committee will work directly with our Division of Market Regulation, with the opportunity to draw on specialized staff support from other offices and divisions as desired.

Turning briefly to the more specific tasks that will and will not be put to the committee, it should not have to concern itself immediately with the first policy objective of the Central Market System, namely, the consolidated tape. On this goal, the participating self-regulatory bodies have made good progress. A revised plan has been submitted to us which we have today declared effective as of May 17, which will start the running of the twenty weeks for the beginning of the pilot period in October, with full operation in February, 1975. After a somewhat stormy beginning, the self-regulatory bodies participating in the program have concentrated on the common interest and deserve much credit for creative statesmanship.

Fortunately, as you know, good progress is also being made on important developments that are not expressly part of the central market system as set forth in the White Paper, but are nevertheless of major significance. I am referring to the development of single, national clearing and depository systems. In each case it appears as though efficient integration can be worked out while preserving some local autonomy for existing facilities. In both of these projects, we are impressed with, and gratified by, the leadership displayed by Stretch Gardiner and Bill Dentzer, respectively, and the willingness to compromise and cooperate displayed by the participating groups. This spirit and this progress are, I am sure, good examples of what we can achieve. In immediate dollars and cents, these developments are certainly as significant as anything else that we are talking about.

Finally, the committee need not concern itself with the unfixing of commission rates except to assume that it will proceed on schedule.

What specific projects do we envision this committee tackling? Just as examples of some of the matters we hope the committee will put on its agenda early, and by no means an

exhaustive list, let me outline some of the areas in which we think this committee can make a meaningful contribution.

One of the principle criticisms of our markets in the past has been that they have become fragmented and compartmentalized. The auction market -- where brokers for buyers have a chance to meet brokers for sellers without the intervention of a dealer -- has not been completely effective, since orders entered in one market center do not have a realistic opportunity to meet orders entered into another market center in our present system. The implementation of the composite quotation system will certainly furnish the means to maximize the opportunity for public buyers to meet public sellers. But, there remain to be considered the ways in which this quotation system can be utilized to enhance the opportunity to permit public orders to meet, if entered in different market centers.

In our Policy Statement on the Structure of a Central Market System, we suggested several ways in which such a quotation system could be utilized to preserve and enhance traditional auction market principles. One was a price priority rule. Simply put, if a buyer has his order represented in the system, another buyer may not come along and purchase the same stock at a lower price until the first

buyer's order is satisfied. The second was a public preference rule. If a public customer and a professional dealer have entered orders to purchase the same securities at the same price, the dealer must stand back, and permit the public customer to purchase the stock first. And we raised the question whether public limit orders should be permitted to participate, at a discount, in block trades, at a cross price. Our initial thinking, which was somewhat tentative, was to permit such participation in smaller blocks, say those up to \$100,000.

Accepting these goals, we recognize that questions have been raised whether there may be other approaches, or different rules, to achieve them better. Hopefully, the committee will be able to sift through these questions and, after considering all responsible views, recommend to us the specific manner in which our goals can be implemented.

The term "equal regulation" has been a term which more often has obscured discussion, rather than enlightened debate. Let me give you an example. Some interested parties have stated that the nondisclosure of third-market trades is one important example of unequal regulation. Those who raise this

argument often conclude that we shouldn't have a consolidated tape or composite quotation system until we have equal regulation. That argument has a decidedly circular quality: we cannot have disclosure until we have disclosure.

Nevertheless, we do agree that participants in the central market system should all be subject to fair and even-handed regulation. This does not mean that we should force all market participants into the same mold, just for the sake of conformity, but, rather, it means that we should analyze closely the different functions performed by various market participants and determine the fundamental rules by which those persons performing comparable functions should all play.

Without very careful consideration, we would not, for example, want to subject block positioners and specialists to exactly the same rules, simply because both groups act as dealers in listed securities. Otherwise, the present exchange rules, which prohibit specialists from dealing directly with institutions and certain others, would have to be repealed or, conversely, institutions would be compelled to deal with other brokers simply to reach the block positioner. These are the kinds of decisions that require the careful thought of experienced securities professionals, as well as government regulators.

On the other hand, it is clear that certain principles, such as the regulation of short-selling activities, should operate the same way for all those who have their transactions printed on a consolidated tape. And, we have already published for comment amendments to our short-sale regulations to accomplish this end.

But what is really important is that we specifically identify and analyze the regulatory areas in which there will be a need for equalizing our regulatory framework.

We have stated that the privilege of making markets in the central market system, and utilizing the quotation system by market makers, should carry with it the obligation to contribute to the orderliness and depth of those markets. But, exactly what form should that regulation take? Should there be a rule designed to ensure that market makers stabilize our markets? If so, what form should such a rule take: a tick test, a daily net balance test, or can other, more meaningful tests be devised? Should there be firm quotation rules? In size? Should there be participation standards? Limits as to quotation spreads? Turnover tests? Tests gauging the "competitiveness" of quotations? Should there be rules designed to prevent market makers from "overreaching"-- that is, buying substantial amounts of stock from the collective book of limit orders above the last sale price? What forms of continuity tests are meaningful?

How should openings be handled? What should be the responsibility of market makers for market orders? limit orders? stop-loss orders? What about primary market protection orders? To what extent will internalized, open competition between market makers eliminate the need for rigorous participation standards?

Similarly, the Commission specifically did not decide whether upstairs market makers -- those firms, including present exchange members, that stand ready to buy or sell medium or smaller size blocks of a limited list of securities from or to their institutional customers at prices close to last sale -- should be compelled to shoulder the responsibility to make fair and orderly markets.

Nor have we yet considered the implications of upstairs market making upon the exchange process of allocating securities. And, when a block positioner trades several large blocks of a listed security, for the time being he is the market for that security. Should the block positioner be subject to well-defined responsibilities to the "after-market" subsequent to a decision to position stock?

I hope these examples are enough to give you a fair picture of the problems this committee will be asked to help solve. Its agenda will get much longer as it gets into operation.

The committee has not been given, and cannot be given, any legal authority. Its success will lie in the persuasive quality of its judgment upon you, upon the self-regulatory bodies and, especially if legal action is required, upon us. In addition to seeking views and assistance from our Division of Market Regulation and other staff personnel, it will be consulting with any other persons or bodies in the industry, or out of it, for that matter, whose views they think may be of value. The extent to which recommendations of the committee will ultimately be reflected in Commission rules or rules of self-regulatory bodies, or both, can be worked out when we get there.

My immediate objective this morning is not really to persuade you of the virtues of the proposed central market system. If you are not already persuaded, it will take more than one more talk. Perhaps the only thing that will do it is time and success. My purpose, rather, is to persuade you that there is a program, that it has substantial authoritative support, as the accountants like to say, and that its further development will be carried forward in an orderly way with competent guidance. I am sure you will have increasing confidence in the self-sacrificing men who have agreed to undertake the burdens of membership on this committee, and we are most grateful to them for doing so.

This program may not be a perfect plan. But I am conscious of the observation attributed to Clausewitz that the dream of a perfect plan is the greatest enemy of a good plan. I am confident that this is a good plan and that it can and will be carried out, and that the result will be a better capital market and a stronger -- and I hope to God more profitable -- securities industry. I urge you all to cooperate to this end.