

# **THE SECURITIES MARKETS**

**A Report, With Recommendations**

**By**

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Early this year, against a background of crisis in the securities industry, former Chairman Bernard J. Lasker and the Board of Governors of the New York Stock Exchange unanimously requested me to undertake a thorough study of the Constitution, rules and procedures of the Exchange. To assist in this undertaking, a committee of industry leaders, not now serving on the Board, was designated to advise, and they have been more than generous with their time and interest. None of the members of this committee is responsible either individually or collectively for the views expressed in this Report. The committee was composed of: Messrs. James W. Davant, Paine, Webber, Jackson & Curtis; Walter N. Frank, Walter N. Frank & Co.; James Crane Kellogg, Spear, Leeds & Kellogg; Gustave L. Levy, Goldman, Sachs & Co.; Clifford W. Michel, Loeb, Rhoades & Co.; Donald T. Regan, Merrill Lynch, Pierce, Fenner & Smith, Inc.; and Henry M. Watts, Jr., Mitchel, Schreiber, Watts & Co. I have also been ably assisted in my work by Mr. Donald A. E. Beer, an independent consultant, and Mr. George A. Jensen, legal counsel, a member of the firm of Peper, Martin, Jensen, Maichel and Hetlage of St. Louis, and by a very efficient secretary, Miss Geraldine Nahra.

In making this study, I sought the views of all segments of the financial community both inside and outside of the securities industry. It became clear very early that neither the study nor my recommendations could be confined to the New York Stock Exchange, and that the securities industry as a whole must be encompassed. Consequently, I have visited with regional securities exchanges from coast to coast, the Investment Bankers Association, the Association of Stock Exchange Firms and numerous other organizations and groups. I have reviewed dozens of pertinent reports treating the major issues and examined most of the new communication systems. During the five months devoted to this study, I have had conferences with several hundred individuals.

In this Report, I have not attempted to set forth detailed analyses with supporting data. The issues have been extensively documented elsewhere. My recommendations and conclusions are intended to identify goals to be pursued in the public interest, without precluding modifications. I would emphasize the fact that

some changes may be appropriate within the major thrust of the study.

When I accepted this task, it was clearly understood that the public interest would be the paramount consideration in appraising the issues.

### **The Public Interest**

The public interest dictates that the primary purpose of a securities market is to raise capital to finance the economy. Without continuous capital formation, our economy could not grow or prosper. It could not provide job opportunities for our growing labor force. It could not sustain a rising standard of living. It could not generate economic opportunities so vital to the health of our free enterprise system. It could not assist government in its programs to lessen social problems such as poverty, pollution and crime. By contributing to the mobilization of capital, a stock exchange serves the entire population.

In fulfilling this principal role, a stock exchange must also serve those who have already committed their capital to finance the economy. It must enable them to reconvert their securities into cash whenever their needs require. Investor confidence in the ability to resell securities on fair terms is critical.

Public confidence depends in large measure on the environment which surrounds a public market. Full disclosure, responsibility and financial soundness of the industry participants are necessary. A multitude of sources of information and opinions about stock values will contribute to proper pricing. Protection of the priority of public orders is important. When stock certificates are immobilized or eliminated, confidence will depend even more than now on financial soundness of brokers and their agency relationship with their customers.

The organization and operation of a securities market must reflect the difference between securities on the one hand and commodities, products and/or services on the other. Securities represent capital. Capital is an indispensable ingredient of every business and industry. The strategic and critical role of capital

means that collapse or distortion of the securities industry could injure many of its customers and the economy of the nation.

Ownership of common stock is shared by 31 million Americans directly and by many more millions indirectly through their participation in pension funds, mutual funds and insurance. The public has financed the United States economy. This makes it imperative that the market should be designed to serve the public, to serve the small investor equally as well as anyone else.

Naturally, a market organized to provide equal and responsible service to more than 31 million Americans must be nationwide in scope. It must maintain maximum liquidity. It must provide a continuous, fair and orderly market with centralized disclosure of all executions of buy and sell orders and other material facts. In my judgment, the auction market is best suited to perform this service.

Historically, the New York Stock Exchange has offered such a market. Since its founding in 1792 under the Buttonwood Tree, it has performed its function so successfully that today the stocks listed on the New York Stock Exchange represent more than half of the total market value of all common stocks publicly traded on all the free world markets.

In recent years, the old familiar patterns in the securities industry have been disrupted by the appearance of two new forces: institutional investors and computers. By mobilizing capital, the institutional investors have acquired the power to influence the way markets are made. Computers, because of the communication systems they make possible, offer the means to improve radically the way markets operate. Both of these forces have developed apart from the New York Stock Exchange. Together, they have had a pronounced impact on the New York Stock Exchange's performance as the principal market.

The result has been that many transactions in securities listed on the New York Stock Exchange have been executed on various other exchanges, and in the third and fourth markets. This dispersion of trading from a central auction market is a fragmentation of that market. This fragmentation has been lauded

by some who contend that competition between markets is desirable. But for competition to be beneficial, it must exist under similar rules and in the same arena. Competition between markets has not been beneficial because it has depended upon unequal regulation which, among other things, has not required full disclosure and equal responsibility of participants. Differences in disclosure of information about activity in these markets and differences in access to these markets have made it increasingly difficult for the public and fiduciaries alike to obtain the best prices available at any given time.

As inflation and inflationary expectations rose in recent years, the securities industry was ill-prepared for the unexpected syndrome of go-go speculation for short-term performance. Volume exploded, prices soared, then later plunged, and distortions became alarming as paper jammed the system. The system was in disarray; it could not stand the strain.

The inevitable breakdown in operations followed. Because the business was more than could be handled, trading days were shortened, and later Wednesday closings were adopted. Burdened with onerous sales costs and plagued with inadequately designed computer facilities, some member firms failed. Others refused to take public orders. Naturally, investors' confidence was shaken. Grave injury to the public was narrowly averted by hastily organized financial rescue operations.

The crisis receded with the help of both the commission surcharge and a rising market. In order to insulate the public from financial injury, Congress created the Security Investors Protection Corporation to be financed by assessments on the members of the industry and backed by the Federal Government.

In retrospect, it is clear that the Securities and Exchange Commission, the New York Stock Exchange and all the other markets and exchanges were caught off guard and were unprepared or unable to cope with the situation. Clearly, what has happened in the past five years calls for reexamination and improvement in the machinery of administration and self-regulation. In response, Congress is in the process of preparing for hearings that seem destined to lead to a new securities act.

If the ills of the industry and its weaknesses are allowed to survive, they are bound eventually to retard new capital formation. The consequences will not be favorable for the economy.

### **Development of a Central Market System**

To serve the interests of the public and the nation, as well as the interests of the securities industry itself, a national exchange system must be developed to provide a single, national auction market for each security qualified for listing. Such a system would integrate the New York Stock Exchange, the American Stock Exchange and the regional exchanges. Because of their geographical locations and their identification with local needs, the regional exchanges have a vital role to play in making a truly national system. To accomplish this, the structure of the market mechanism must be redesigned and modernized. The characteristics of this national auction market should include the following:

1. A market which provides maximum opportunity for public buyers and sellers to effect trades directly through their agents, as opposed to a market in which the public must trade with dealers trading for their own account;
2. A market in which the activities of broker-dealers, specialists and other professionals are uniformly defined and regulated and subordinated to the interests of the public;
3. A market which provides fair commission rates to all investors;
4. A market which permits equal access for a maximum number of broker-dealers and their customers, regardless of geographical location; and
5. A market which provides for equal access by all investors to material information about both the market itself and the securities traded in that market, including centralized reporting of price and volume of all trades.

The creation of such a national exchange system would provide

one market for each listed security. There could be two or more divisions within this national exchange system. The present listing requirements of the New York and American Stock Exchanges might provide appropriate listing requirements for two such divisions. Whether all securities which meet the listing requirements for a particular division of the national exchange system should be required to be listed for trading in that division should be considered. Securities which are not listed on any division of the national exchange system would be traded in the over-the-counter market. Securities should be traded either in a single division of the national exchange system or in the over-the-counter market, not in both markets.

Suitable regulations will be required to coordinate the over-the-counter market with the national exchange system and to protect the integrity of each.

A committee of experts, including representatives from the major exchanges, should be appointed by the Securities and Exchange Commission and charged with the planning and design of a national stock exchange system which meets the requirements set forth above. New legislation will be required in order to implement such a system.

### **Reorganization of The New York Stock Exchange**

The New York Stock Exchange has, to some extent, all of the characteristics prescribed above for the proposed national exchange system. To improve its present role, the New York Stock Exchange should be reorganized. This reorganization should proceed promptly and not await formation of the proposed national exchange system. The principal objectives should be:

1. To give proper recognition in the governing board of the Exchange to its quasi-public nature and the respective interests of the public, the companies listed on the Exchange and the members of the securities industry involved.
2. To provide broad access to the public auction market for all

brokerage firms which meet necessary standards and will be subject to equal regulation.

3. To create an organization which, through the public representation on its governing board and the authority and independence of its management, will strengthen self-regulation and answer the prevalent criticism that member firms of the New York Stock Exchange cannot be expected to discipline themselves.
4. To permit and encourage the principal officers and partners within the member firms to serve on the governing board without respect to business background, e.g., the floor, the back office or the New York metropolitan area.
5. To transfer voting power from the individual members to the member firms and to provide a means for its redistribution so that each member firm could have voting power more closely related to its investment and its share of exchange transactions.
6. To change the present seats into shares, without destroying their market value.

In accordance with the foregoing objectives, the following plan of reorganization is recommended:

1. **Form of Organization** – The Exchange would be a corporation.
2. **Board of Directors** – The Board of Directors would consist of twenty individuals plus a voting Chairman whom the Board would elect. Ten directors would be elected by vote of the member firms from the officers, partners and proprietors of the member firms, and ten directors would initially be elected from the public by vote of the member firms. Initially, two special nominating committees should be appointed by the present Board of Governors of the New York Stock Exchange. One committee should consist of seven public representatives. This committee, after considering the recommendations of representative listed companies and of organizations such as the Investment

Company Institute, the American Bankers Association and associations of insurance companies, would nominate the ten public members of the first Board of Directors of the reorganized Exchange. It is recommended that two of the ten initial and successor public directors should be persons from the public recommended by the Securities and Exchange Commission. The other committee should consist of seven members of the Exchange and, after consultation with members and other interested persons and organizations, would nominate the ten member firm representatives to be elected to the first Board.

- a) **Public Directors** – The public members should include representatives of the companies listed on the Exchange and representatives of all segments of the investing public, including financial institutions, such as mutual funds, banks, trust companies and insurance companies. After the first election, to assure their continuing independence, the ten public directors would elect their own successors. The term of office of each of the ten public directors would be three years. The terms should be staggered so that approximately one-third of the public segment of the Board would be elected annually. No public director should be permitted to serve more than two terms of office.
- b) **Member Firm Directors** – The ten directors elected by the member firms would serve as a nominating committee for the selection of candidates to succeed them. The member firms would also have the right to nominate member firm directors from the floor. Successor directors should be elected by the member firms through cumulative voting rights. To ensure minority representation through cumulative voting, the term of office of the ten member firm directors would be one year, and no member firm director could serve more than six terms.
- c) **Function and Responsibility** – The Board of Directors would be a policy-making body with authorities and

responsibilities comparable to those of the Board of Directors of a business corporation. Like most business corporations, the Board's authority should include, subject to the right of the shareholders to over-ride the Board, the power to amend the Constitution and Rules of the Exchange. None of the board members, other than the Chairman, would be directly involved in the day-to-day administration of the Exchange. (Some of the self-regulation of the Exchange would continue to be the responsibility of representatives of the member firms. For example, there should continue to be a committee for the floor of the Exchange which would be comprised of member firm representatives on the floor.) All directors should be reimbursed for all expenses incurred in performing their duties, and the public directors should also be compensated for their time and responsibility.

3. **Officers** – The principal officer of the Exchange would be the Chairman of the Board of Directors who would be the chief executive officer of the Exchange. The Chairman would be elected by the Board of Directors and would be a full-time paid employee who would be required to sever any ties with any member firm of the Exchange or any other business. As chief executive officer, the Chairman would have all of the customary powers and responsibilities of the chief executive of a business corporation. He would preside at all meetings of the Board of Directors or of the shareholders. Subject to the approval of the Board of Directors, the Chairman would appoint a president (who would be his chief operating officer) and all other necessary officers.
4. **Conversion of Seats and Voting** – The present seats on the Exchange would each be converted into ten shares. All such shares would be owned and held by and in the name of the member firms (which could be corporations, partnerships or individuals doing business as member firm sole proprietorships). Each share would entitle the owner thereof to one vote on all matters voted upon, with cumulative voting

rights for the election of the ten non-public members of the Board of Directors.

5. **Member Firms** – Ownership of one share would make the owner thereof eligible to become a member firm of the Exchange with the right to deal in all securities listed on the Exchange in accordance with the rules of the Exchange, but the ownership of ten shares would be required to enable a member firm to place a representative on the floor of the Exchange or to be a clearing member of the Exchange. All member firms would be required to meet the same standards and would be governed by the same rules. Floor representatives of member firms would be required to meet specified standards and to comply with the rules of the Exchange, but this would not relieve member firms of their responsibility. A member firm would be required to own ten additional shares for each additional representative on the floor of the Exchange. The initial purchase of any shares in the Exchange by a person who was not then a member firm would be subject to such purchaser meeting all of the requirements of the Exchange for membership and would subject such purchaser to all appropriate rules and regulations of the Exchange. Since all shares of the Exchange would be owned by the member firms, there would be no need for any device such as an a-b-c agreement. This would not preclude an individual from having any type of agreement desired with a member firm with respect to his acquisition of shares from such member firm, but no shares in the Exchange would be transferred to any such individual unless such individual met all of the requirements for becoming a member firm.
6. **Transfer of Shares** – Member firms of the Exchange could transfer shares of the Exchange among themselves, thereby increasing or decreasing their respective voting rights and amount of representation on the floor of the Exchange, subject to the following:
  - a) Any member firm which desired to clear transactions on the Exchange or to maintain a representative on the floor of the Exchange would be permitted to purchase

and hold ten shares irrespective of any other limitation or restriction.

- b) To the extent that a member firm's percentage of share ownership exceeded its percentage of total member firm business with the public, it could, if it desired, sell the excess shares, but could not purchase additional shares; to the extent that a member firm's percentage of share ownership was less than its percentage of total member firm business with the public, it could, if it desired, purchase additional shares, but could not sell any shares. The exact formula for the determination of minimum and maximum shareholdings will require further detailed definition, but the aim should be to limit voting power by the amount of business done with the public. It may be desirable to require a new member firm to purchase additional shares, up to a total of ten, as such firm's percentage of total member firm business with the public exceeds its percentage of share ownership.
- c) A specialist firm would be required and limited to purchase and hold that number of shares necessary (on the basis of ten shares for each representative on the floor of the Exchange) to enable such specialist firm adequately to perform its duties in accordance with the applicable rules of the Exchange. Thus, the number of shares which a specialist firm could purchase or sell would depend upon the number of persons it needed on the floor to provide adequate service for the securities traded.
- d) The number of shares which could be purchased or sold by an odd-lot dealer would also be determined by and limited to the number of floor representatives such odd-lot dealer requires in order to provide adequate service.
- e) Registered floor traders and \$2 brokers not affiliated with any other firm would be considered member firms, and each would be required to own neither more nor less than ten shares.

As a result of the foregoing, all shares in the Exchange would be owned and voted by the member firms in the Exchange, and, except in the case of an individual doing business as a member firm, shares would not be owned by individuals. The representatives of member firms on the floor of the Exchange would be designated by the member firms, subject to approval by the Exchange.

### Capital Requirements and Related Matters

Many member firms of the New York Stock Exchange need additional capital to meet present and future requirements. The basis on which this capital will be acquired is very important. The events of recent years have demonstrated dramatically the importance of permanent equity or "cash" capital, and the need for permanent capital cannot be over-emphasized. The trend in recent years toward the corporate form of doing business by member firms is desirable and should be encouraged because it tends to build capital through retained earnings and to attract capital on a permanent basis. Public ownership of member firms is a sound development which may in the future supply a substantial part of the growing capital needs of the securities industry.

The amendments to the Exchange's capital rules adopted by the Board of Governors on July 15, 1971, are intended to correct, over a period of time, most of the deficiencies which became apparent in the stress of the past few years. There should be continuous review of the capital needs and the capital rules and rigorous enforcement of these rules. Consideration should be given to improving or replacing the "aggregate indebtedness to capital ratio" as the yardstick for measuring the adequacy of capital. Consideration should also be given to increasing further the requirements for entry into the securities business, particularly those affecting the amount and permanence of initial capital.

The need for tremendous amounts of capital to finance the day-to-day operations of the industry precludes any arbitrary or sudden change in the present use of free-credit balances. Much of Wall Street could not operate today without these balances. However, it would be reasonable to impose gradually a segregation

requirement with respect to a percentage of properly defined credit balances which would require investment in unencumbered short-term United States Government and Government-agency securities.

The segregation of customer securities is another aspect of member firm operations where improved regulations and vigorous uniform enforcement is required.

Greater emphasis should also be placed upon the development of improved accounting and auditing procedures with uniform reporting. This will require a joint effort by the Securities and Exchange Commission, the accounting profession and the Exchange.

### **Specialists and Block Positioners**

A market with liquidity is one in which the investor can readily convert his securities into cash at a price close to the last sale. On the New York Stock Exchange, liquidity has depended ultimately upon the specialist system which is designed to absorb the frequent imbalance between buy and sell orders. The increasing institutionalization of the market has placed heavy demands upon the specialist system. The growth of the block positioners has helped provide the liquidity demanded by the institutions. A high degree of understanding and cooperation is necessary between the specialists and block positioners to maintain a market with good liquidity.

There has been a great deal of criticism of the role and function of specialists. However, no better system of maintaining a continuous and responsible market has been suggested. The capital resources of specialists, however, should be increased to meet the requirements of today's trading, and methods should be developed to encourage and enable specialists to improve performance of their functions in instances where securities are offered in unusually large volume.

Allocating specific securities to specialists and maintaining effective markets in them are the direct responsibility of the Exchange. The allocation procedure must, at all times, reflect the

ability to provide effective markets in the public interest. Allocations of securities, which are valuable franchises, should be governed by clearly defined performance criteria against which all specialists should be judged. Once such criteria are established, specialists would have the incentive to meet them, and as a result, effective regulation of the specialist system would become an easier task. Authority with respect to the allocation of newly listed securities and the reallocation of presently listed securities should ultimately be vested in the staff of the Exchange, subject to review by the Board of Directors. Effective regulation of the specialist system requires the transfer of this authority to the staff of the Exchange.

In general, better administration of rules and regulations pertaining to specialists is needed. More, rather than fewer, specialists and market makers are needed, who are better capitalized, with clearly defined responsibilities and subject to uniform regulations.

Block traders, who have recently assumed an increasingly important role in the market, present a problem of growing urgency. Block trading, unless prudently conducted, can substantially frustrate public participation in the market and the orderly operation of the market. Rules and regulations specifying the qualifications for those firms which may act as block positioners and defining their obligations to the public marketplace should be developed, and a closer working relationship between block positioners and specialists should be required.

### **Unequal Regulation of Markets**

Unequal (different) regulation exists both within the listed market among the exchanges and between the listed market and the over-the-counter market.

Under the Securities Exchange Act of 1934, each registered national securities exchange has the power to adopt its own rules, subject to the jurisdiction of the Securities and Exchange Commission. As might be expected, there is a substantial lack of uniformity in the rules adopted by the various exchanges. In

general, the rules of the two largest exchanges, the New York Stock Exchange and the American Stock Exchange, are the same, but rules of the regional exchanges differ in extremely important respects from those of the New York Stock Exchange and, sometimes, from one another. As a result, some of the important areas where there is now unequal regulation among the exchanges are as follows:

1. Regulation of specialists, including restrictions on the solicitation of orders from financial institutions as provided in Rule 113 of the New York Stock Exchange;
2. Institutional membership on the various exchanges;
3. The use of reciprocal commission splitting arrangements, including instances where the result on some regional exchanges is a rebate or discount to an institutional customer;
4. Off-board trading by members which is very limited in the case of the New York Stock Exchange under Rule 394;
5. Requirement to print all executions on a tape; and
6. Restrictions on short sales of odd-lots.

If each of the exchanges listed and traded different securities, these differences in rules might not be of any great consequence, but where securities are listed and traded on more than one exchange, various kinds of differences in regulation can, and do, result in undesirable practices. Regulatory restraints imposed by the New York Stock Exchange, for example, are circumvented by the execution of trades in listed securities on regional exchanges with more permissive standards.

The foregoing differences in regulation must be resolved. New legislation by the Congress will undoubtedly be required to achieve complete uniformity. The best solution would be to include the major regional exchanges in a national exchange system which would have the same rules for all members. In order to prevent further fragmentation of the market pending new legislation and the creation of the national exchange system, it is

recommended that the Securities and Exchange Commission take appropriate action to resolve all differences in regulation to the extent possible within the scope of its jurisdiction.

The listed markets and the over-the-counter markets in the United States are very different from each other and to an extent require substantially different regulation. Most of the securities traded in the over-the-counter market are not listed on any exchange, and, because of the relatively small number of shares outstanding or in the hands of the public, are not suitable for trading in an auction market. The difference in regulation between the two types of markets does not of itself cause a problem with respect to those securities. In recent years, however, the volume of trading in the over-the-counter market of securities listed on exchanges (the so-called "third market") has been increasing and the difference in regulation becomes important. It is difficult to assess the effect of such third-market trading of listed securities on the quality of the present public auction market, but there is no doubt that the growth of the third market presents a danger to the maintenance of fair and disclosed pricing and to the regulatory system. If the transactions now being executed in the third market were executed on the Exchange, they would unquestionably enhance the depth and liquidity of the central public auction market, and, when a national exchange system is created, such transactions should be effected in that market.

### **Institutional Membership**

All of the arguments on both sides of the question of institutional membership have been weighed and considered. Public discussion of the subject has been confused by the concentration upon the question whether institutions should be entitled to access to Exchange membership so that they may benefit by saving commissions. Appropriate commission charges for institutional orders are a separate question.

The question of institutional membership involves several considerations. One is the concentration of economic power which might result from institutional membership. Another is that institutional membership could lead to a market dominated by

dealers dealing for their own account and tend toward the elimination of the agency relationship between broker and customer. A third, and perhaps paramount consideration, is the necessity of recognizing and preserving the difference between the securities business and other businesses. This separation should be maintained not only to facilitate regulation, but also because of the unique role that the public exchange auction market plays as a very sensitive part of the mechanism of the free enterprise system. Accordingly, it is recommended that the primary purpose of every member organization and any parent of any member corporation should continue to be "the transaction of business as a broker or dealer in securities" as presently provided in New York Stock Exchange Rule 318. This rule, in effect, prohibits membership by banks, trust companies, insurance companies, mutual funds and other institutions. It should be noted that the purchase of 25% or less of the voting securities of a member corporation by an institution is not prohibited.

If institutions are denied membership in the New York Stock Exchange, as herein recommended, member firms of the New York Stock Exchange should be required to divest themselves, over a reasonable period of time and in a manner which will protect the interests of the shareholders of such funds, of any direct or indirect ownership or control of management or advisory companies of open or closed-end management investment companies, and any investment advisory contracts between member firms and such companies or their managers also should be prohibited in order to avoid the use of such contracts to effect control of the operation of such companies.

### **Money Management By Member Firms**

Unavoidable conflicts of interest arise when money management and brokerage functions are combined within a single profit-making firm, regardless of whether a fee is paid for investment advice. It is believed, however, that these conflicts of interest have been reasonably well handled by the member firms.

Serious consideration has been given to the frequent suggestion that the clearest solution to the whole problem of money

management would be to separate all management and brokerage. However, giving investment advice, historically, has been an inherent and logical part of the brokerage business. Accordingly, except for the prohibition previously recommended with respect to open or closed-end management investment companies, member firms should be permitted to engage in all other forms of money management, but they should be prohibited from crediting commissions against any fee charged for investment advice.

### Negotiated Commissions

Setting commissions has been one of the most difficult problems in the industry, and it has caused constant differences between member and non-member brokers and the exchanges. The difficulties of determining a fixed commission schedule are major, but so-called negotiated commission rates may cause equal difficulty.

The term "negotiated rates" is only accurate in some cases. For the millions of individual investors, there will be no negotiation. Brokers will determine their own rates, and the individual investor will either pay them or will not trade. Undoubtedly, there will be "price leadership." Large member firms with nationwide facilities will fix rates based on their own volume and costs. Smaller brokers will have to follow these rates to a large extent.

Only in the case of very large investors, usually institutions, is there likely to be any negotiation. Even here, special rates for particular customers are likely to be more frequent than negotiated rates. Commission charges for institutional orders can be given appropriate treatment within a fixed commission structure. The resolution of this problem does not of itself require negotiated rates.

The question is whether the industry will be better able to function in the public interest if its commission rates are fixed and specified by the Exchange and the Securities and Exchange Commission, or if they are to be determined by each member subject to the sanctions of the anti-trust laws. This is the focal point on which this issue should be resolved.

The success with which capital has been raised to finance the economy in the United States is due in part to the dispersion and local activities of a multitude of broker-dealers. Fully negotiated rates may cause a substantial concentration of the securities business in a few large firms. Because of the strategic importance of the securities industry to the operation of the free enterprise-capitalistic system, control of this industry cannot be permitted to be concentrated in the hands of a few persons or firms. Such a concentration of power could not be tolerated even on the grounds of efficiency.

Negotiated rates may not have this effect. They may only serve to eliminate the inefficient, poorly managed broker-dealers. No one knows the answer to this question, but an abrupt change to fully negotiated rates would be imprudent at a time when the industry needs continued earnings to accumulate and attract capital. The experiment now under way with negotiated commissions on transactions above \$500,000 requires experience and analysis before the Securities and Exchange Commission and the exchanges proceed further.

### **Exemption From Anti-trust Laws**

Under the Securities Exchange Act of 1934, Congress has delegated regulatory responsibility to the national securities exchanges that register under the Act. The Securities and Exchange Commission is given broad supervisory and regulatory powers over the registered exchanges. Although the Exchange Act specifically contemplates collective action by exchanges and their members in establishing and enforcing rules, no express exemption from the anti-trust laws is provided. The legislative history of the Exchange Act sheds no light on this matter. It should be noted, however, that at the time that Congress was enacting the Exchange Act, the applicable court decisions suggested that stock exchanges were not in interstate commerce, and, therefore, it may have been thought unnecessary to provide specific anti-trust exemption.

It was not until 1963 that the question of reconciliation of the Exchange Act and the anti-trust laws was first considered by the United States Supreme Court. The Court held that actions taken

by an exchange to effectuate self-regulation were subject to anti-trust challenge where the Exchange Act made no provision for Securities and Exchange Commission review. The Court expressly left open the question as to the extent of anti-trust protection afforded by the existence of the Securities and Exchange Commission. This 1963 case is the only decision by the Supreme Court on this question. The recent decision by the Seventh Circuit Court of Appeals held that even where an exchange's self-regulatory activity was subject to overall supervision of the Securities and Exchange Commission, and the Securities and Exchange Commission had the power to order changes in an exchange's rule, an exchange was nevertheless subject to anti-trust liability unless it could affirmatively show that the particular rule challenged was "necessary to make the Exchange Act work."

The Court decisions to date leave the question of anti-trust exemption for exchanges far from clear. Consequently, exchanges face the choice of either regulating at their peril, or not regulating at all. This is an untenable position for the exchanges which are required to regulate their members under the Securities Exchange Act of 1934. This dilemma is an obvious deterrent to effective self-regulation which must be remedied.

A reorganization of the New York Stock Exchange substantially along the lines of the plan herein proposed will properly reflect the Exchange's quasi-public nature and qualify it for exemption from the anti-trust laws. Accordingly, it is recommended that the Exchange ask the Congress to enact legislation granting all registered national securities exchanges certain immunity under the anti-trust laws. The scope of the immunity granted to the exchanges should be coexistent with the scope of the Securities and Exchange Commission's control of the exchanges under the Exchange Act, so that no action or omission by a registered national securities exchange in performing any of its duties of self-regulation under the Exchange Act which are subject to review by the Securities and Exchange Commission could give rise to any claim under the anti-trust laws.

### **Role of the Small Firm**

The role of the small brokerage firm should not be overlooked.

It has contributed to the health and strength of the economy by raising capital to finance new ventures and by serving the needs of small investors scattered across the nation, in short, by broadening economic opportunity. In the course of the many changes which will inevitably take place in the securities industry, care should be taken not to cause the elimination of efficient small firms.

### **Foreign Brokers**

Purchases of securities of United States companies by foreign nationals is a welcome infusion of capital which should be encouraged. It helps this country's balance of payments.

Consideration should be given to revising New York Stock Exchange Rule 314.14 so that broker-dealers controlled by nationals of countries that accord similar privileges to United States broker-dealers would be eligible to become members of the New York Stock Exchange if they comply with the same standards for membership that are required of domestic brokers. The rules prohibiting institutional membership would also apply to foreign controlled broker-dealers.

### **Elimination of the Certificate**

The state of the art of computer communication technology now greatly exceeds applications in the securities markets. A major obstacle to efficient utilization of the available communication technology is the stock certificate. Delays and difficulties in the transfer of stock certificates have already contributed to the collapse of many firms and were among the major factors responsible for curtailment of trading hours in 1968. Universal cooperation towards a single solution to this common problem is the only sensible approach.

To alleviate the certificate problem, the New York Stock Exchange should continue to expand its depository (CCS), which is already serving its members, and to cooperate with the Banking and Securities Industry Committee (BASIC) so that it can establish an expanded nationwide comprehensive depository as early as 1973. This is the optimum interim solution. Its success

depends on universal participation and support by all broker-dealers and their customers. Broader participation and scope should be sought promptly. Development must proceed along lines which will be fully compatible with future elimination of certificates once they have been fully immobilized.

Total elimination of the stock certificate, which has been advocated by Mr. William J. Casey, Chairman of the Securities and Exchange Commission, should be the eventual objective to be reached as soon as possible. A period of five to ten years will probably be required to do this. Public confidence, numerous state laws and inadequate standardization of transfer agents are complicating factors. Elimination of the certificate is a matter of such over-riding importance that it deserves action by the Congress.

Elimination of the certificate will not eliminate the paperwork associated with securities ownership, but it will greatly increase the industry's capacity to handle a larger volume of business. It should also significantly reduce member firms' operating costs and permit an eventual reduction in commissions.

Public confidence depends largely on an environment of financial soundness. Today, financial soundness is heavily dependent upon commissions as the major source of revenue. When certificates become immobilized or are eliminated, the relationship between the public customer and his broker will change drastically for most. Brokers will act as custodian for the "book entry" record of all of each customer's security holdings. A continuing management relationship will replace the intermittent agency relationship so common today. A new revenue structure to reimburse brokers may become advisable to reflect the new circumstances.

Elimination of the certificate will not be plausible until there is greater coordination between all the various entities involved in the process of transferring the certificate record of ownership from one owner to another. Lack of such coordination contributed to the long delays in delivery of stock to the public in recent years. If the certificate is going to be eliminated eventually, the public must have assurance that ownership records will be

transferred accurately and promptly. This problem deserves further study.

It is hoped that all action towards a solution to the certificate problem will be fully coordinated with the progress already made in the interest of achieving a single national solution at the earliest possible time.

### Communication Technology

At one time, the floor of the New York Stock Exchange used new communication systems to make itself the largest market, as well as the leading market of the world. In recent years, the revolution in computer communications has largely passed the floor by. While others are utilizing modern communication equipment and networks to serve their customers, the members of the New York Stock Exchange have postponed improvements and preserved outmoded manual systems on the floor. The largest customers have responded by going where their needs are served better. But the public has little choice. They must rely on the facilities of the New York Stock Exchange. As the market has become increasingly fragmented, the New York Stock Exchange can no longer guarantee to the public either the best execution or full disclosure of price and volume for all sales in its listed stocks.

One area in which the New York Stock Exchange can re-establish leadership is in the development of a single "consolidated exchange" tape which is technologically feasible today. It should be undertaken immediately to provide complete disclosure of material information to all investors. Price and volume for every transaction in any stock listed on the New York Stock Exchange should be reported on this consolidated tape at the time of execution regardless of where the trade took place, whether on the New York Stock Exchange, on a regional exchange, in the third market, in the fourth market, or anywhere else. It is logical that the New York Stock Exchange should initiate plans to create this tape for all stocks listed on the Exchange. It will undoubtedly require Securities and Exchange Commission coordination and regulation to require complete reporting of the appropriate information by each source. There appears to be no reason why

this consolidated tape cannot be activated by the middle of next year as a first step towards full disclosure in an integrated central market system. This would be an appropriate time to abandon quoting prices in eighths of a dollar and to adopt tenths as the unit of price changes.

The farsighted cooperation of the New York Stock Exchange, the American Stock Exchange and the Association of Stock Exchange Firms in the development of SECTOR, a nationwide, bulk communication network, lays the ground-work to support member firms' modern communication systems on an economical basis. The consolidation of certain computer facilities of the New York Stock Exchange and the American Stock Exchange will provide maximum economy in their use. Development of the "locked-in trade" and the "specialists electronic book" will help members serve all of their customers in the "total communication" environment which is just around the corner. Application of computer communication systems to the New York Stock Exchange will be essential to prepare it to serve as an integral part of the future national exchange.

In the past, access to an exchange market for securities was restricted to physical presence at a single geographical location. The floor of the New York Stock Exchange was designed and structured to create an auction market in which full disclosure and clearly defined responsibility could be enforced because of the physical limitations on participation. In the future, modern communications systems will permit access to an exchange market for securities regardless of geographical location. Access to the communication system will become synonymous with access to the Exchange. NASDAQ suggests the possibilities. It challenges the New York Stock Exchange to improve on what has gone before.

## Summary

Many of the recommendations made herein can be implemented by the New York Stock Exchange acting alone, others require action by the Congress, the Securities and Exchange Commission or the other exchanges either acting alone or together with the New York Stock Exchange. The following is a brief outline of the principal recommendations in each category:

### **Recommendations To Be Implemented By The New York Stock Exchange Alone:**

1. Reorganization of the New York Stock Exchange.
2. Continuous review and emphasis on the financial soundness of member firms.
3. Additional regulation and improvement of the role of the specialists and the block positioners.
4. Prohibition of institutional membership and prohibition of member firm management of mutual funds.
5. Prohibition of crediting commissions against any fee charged for investment advice.
6. Greater use of modern communication systems.

### **Recommendations To Be Implemented By The Congress, The Securities and Exchange Commission And The Other Exchanges Either Acting Alone Or In Concert With The New York Stock Exchange:**

1. Development of a national exchange system providing a national auction market for each listed security.
2. Consideration of increased requirements for entry into the securities business by broker-dealers.
3. Adoption of appropriate segregation requirements with respect to free-credit balances.

4. Resolution of the differences which result in unequal regulation and the elimination of the third market, preferably through the development of a national exchange system.
5. Additional time to be given to the experiment with negotiated rates before any further change is made.
6. The enactment of legislation granting anti-trust exemption to the exchanges coexistent with Securities and Exchange Commission oversight.
7. A coordinated effort to eliminated the stock certificate.
8. Development of a "consolidated exchange" tape.

### **Conclusion**

The securities industry may be on the threshold of another period of great expansion. The number of shareholders and the volume of trading may more than double in the next ten years if the character of the market is oriented in favor of the public. The challenge is to reorganize and to improve the securities industry so that it will serve the public and the national economy better. The principal thrust should be the creation of a national exchange system and reorganization of the New York Stock Exchange. The utmost effort and cooperation will be required from all of the exchanges, the National Association of Securities Dealers, the Securities and Exchange Commission and the Congress to accomplish this.

