THE THIRD MARKET —

Past, Present and Future

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I have been asked to talk about the Third Market, its past, present and future. In a very few words, its past is obscure, its present highly controversial, and its future exceedingly unpredictable. However, to properly understand it, we must view it in relation to other markets. This excludes any consideration of that area of the business that has to do with the underwriting or distribution of new securities, which is an entirely different phase of the securities business. I will confine these remarks to the various methods of moving existing and outstanding securities from one holder to another, and related problems.

The name Third Market was originally used by the Securities and Exchange Commission in the "Special Study of Securities Markets" published in 1963. For the purposes of that study, the Securities and Exchange Commission divided the securities markets into two main areas: The Exchange Markets and the Over-the-Counter Market – markets number one and two, if you wish. Along with these two basic market types was found to exist a growing group of dealers, not members of a stock exchange, who maintained continuing two-sided trading markets in common stocks also listed and traded on a National Exchange. The Study Group attached enough importance to this phase of the business to call it the "Third Market."

Before analyzing the particular attributes of the Third Market, let's take a look at the characteristics of the Exchange procedure and the Over-the-Counter methods and see to what extent they differ. They are two entirely different markets, two different techniques. The Stock Exchange is an auction market, while the Over-the-Counter market is a negotiated procedure. Orders are given to Stock Exchange brokers to buy and sell and these orders are funneled into a central market place. If the buy and sell orders are exactly equal and arrive at the same time, they are matched off against each other. An imbalance one way or the other has a tendency to affect the price. A specialist acting as a dealer has the responsibility to maintain an orderly market by buying or selling for his own account and naturally takes a profit. Most auction markets are continuous, hence, many orders just miss meeting each other and are therefore bought or sold by the specialist.

In the Over-the-Counter market, especially the Third Market segment, dealers known as market-makers indicate a willingness to buy and sell a security at a net price. Custom requires that they quote a two-way market, except under unusual circumstances. They are not brokers or agents, but principals acting for their own account and risk. Customers can go directly to the market-maker and buy or sell at a net price. However, with respect to unlisted issues, it is more likely the transaction will be made by other broker-dealers acting as intermediaries or agents.

While the designation Third Market is relatively new, the practice has existed for many years. To trace its development I would like to dwell on my own experiences and observations over the years. I recall the early twenties in California at which time the institutions confined their investments almost exclusively to bonds. A fairly active bond market prevailed on the Exchanges in San Francisco and Los Angeles, but it was difficult to buy in any kind of size without having to wait a considerable period of time. Our first venture in trading listed securities was to accumulate odd lots of bonds and present them to banks and other institutions when we were able to offer a block.

By the middle twenties the bond market was largely on the street. Local utility companies, principally the Pacific Gas & Electric Co. and Southern California Edison Co. were selling their Preferred stocks to their customers and this gave us an opportunity to maintain a Secondary or Over-the-Counter market in Utility Preferreds and we found this type of security was beginning to have some appeal to institutions. While the bond market has disappeared from the Pacific Coast Exchange, a good market still exists for Utility Preferreds and Common stocks.

I might add that we survived the crash of 1929 probably because we had developed an institutional business.

In the thirties the Utility Holding Company Empire had disintegrated and the operating companies were financing through the sale of their common stocks. This caused several large non-member underwriting houses to develop an interest in trading Utility commons and many institutions to begin buying them in a small way. There was a definite emergence of the off-board or Third Market at this time. Our development and interest has paralleled the increased interest and growth of the Institutional Market. We have increased the list of securities we trade as the institutions have increased the scope of their holdings. Their buying interest has been the main factor in determining our activity. Today there is a tremendous institutional interest in many types of industrial stocks.

The Third Market is a segment of the Over-the-Counter market and has most of its characteristics but retains its own individuality. It is designed for and is almost exclusively available to institutions and broker-dealers. May I quote one paragraph from the "Special Study Report":

> "At the core of the Third Market are the broker-dealers actively engaged as principals in buying and selling New York Stock Exchange listed securities over-the-counter on a continuous basis and holding themselves out to institutions and other broker-dealers as making markets in such listed securities as a continuous operation."

We, who are known as market-makers, are not members of the New York Stock Exchange on which most of the securities we trade are listed; we nearly always act as a principal for our own account and rarely as an agent. Our customers come directly to us and negotiate their trades – they are practically all professional. They include all kinds of institutions, such as banks, trust accounts, foundations, pension and profit-sharing funds, university endowment funds, mutual funds, insurance companies and broker-dealers acting as intermediaries. I would be reluctant to see this type of business expand beyond professional customers to individual investors. We expect our customers to deal at arms length with us and actually it is they who make the final decision to buy or sell. We quote the price or market at which we will trade and they either accept or reject. The customer holds control of the order until it is consummated which usually takes place on the initial telephone call.

Prior to 1963 there was very little actual knowledge of the size and scope of the Off-Board Market. The "Special Study" estimated a Third Market volume in 1961 of 43,000,000 shares or 3.3% of the volume on the New York Stock Exchange. This was done in 270 stocks, principally by seven firms. The volume today is much larger, but has not kept pace with the increased volume on the Exchange. It must be kept in mind that this business is in a limited number of stocks and only with professional customers. The percentage of business done in certain individual stocks is much greater – in some cases amounting to 25% or more of the New York Stock Exchange volume.

Market-makers are required to report their volume by stocks to the S.E.C. and this information is published quarterly by the Commission in its Statistical Bulletin.

I have tried to describe the operations of the Third Market, and now I would like to discuss the purpose behind it and its advantage to the customer. Our firm has had a leading part in its development for more than forty years. Our philosophy and approach have always been to devise a system that makes it possible for a knowledgeable, sophisticated and professional customer to buy or sell a security of his own choice in the easiest and quickest possible manner and at the best price. This, we think, the off-board market-makers offer. It also allows the customer to control the order until a final decision is made. In other words, he knows exactly what he has to pay or what he will get before he executes the transaction.

Market-makers customarily quote markets with a half-point spread. This is 50¢ a share between the price they will pay and that at which they will sell, and I might add, they rarely average anywhere near that much. An average overall profit of 25¢ to 35¢ a share is more realistic.

Market-makers cannot do all things for everyone. They are sometimes better buyers than sellers and vice versa. However, our very existence depends on our ability to fill orders day after day. If we back away on small amounts or too often on large blocks, we will soon lose our customers. Experience shows that the Third Market has stood up exceptionally well during some trying times.

There has been considerable talk about the detrimental effect of this activity on the New York Stock Exchange, particularly in regard to the depth and liquidity of the Big Board Market. Our own feeling is that the Third Market has a tendency to supplement the Board Market and add to the size and stability of the overall market. The "Special Study" group put it this way:

> "Finally and perhaps most importantly, the Third Market, whatever its effect on the primary market, provides the public customer with overall markets of greater depth. The institutional customer with an order too large to be handled in its entirety by the specialists can and often does trade with the market-makers and

thereby derives the benefit of their resources as well as those of the specialists. In this respect, the market-makers function as auxiliary specialists and add depth to the markets available to the institutional trader. As indicated above, the "Off-Board Market" may be viewed as competitive from the perspective of the New York Stock Exchange, but from the reference point of the institutional customer who is able to utilize the combined resources of both markets, it is complementary."

A few days ago the New York Stock Exchange changed their Rule 394B. This is the rule that has prohibited their members from trading listed securities with non-members at a net price. They are now permitted, when acting as agent for a customer, to execute the order with a recognized off-board market-maker at a net price if the price is better than they are able to secure on the Exchange. This change emphasizes the growing importance and acceptance of the Third Market.

It is too soon to appraise its effect, or to foretell its future impact on the business. Our preliminary feeling is that it will probably have a stabilizing influence on the stock market and bring about a closer, more efficient market for the institutional buyer. It is quite likely the forerunner of other changes, some of which are currently being talked about, such as a reduced commission on large blocks. The trend seems to be toward narrower profits for most areas of the business. On the other hand, there is every reason to believe that activity and volume should increase in the future.