The Securities Industry: A Copernican View

Remarks By

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By this time you should be aware of the fact that major changes are developing in the structure of our securities markets. The focus of these changes has been on the market for listed stocks; however, they will ultimately affect every part of our industry.

Change makes people uncomfortable, especially when its direction and resolution may not be clear. I would like to spend a few minutes giving you my impression of the significance of present trends as they relate to the industry not only in Los Angeles but throughout the country.

A necessary first step in dealing with change involves breaking old, fixed mental images. Long ago a fellow named Copernicus, contrary to the established belief, discovered that the other planets, the sun and the stars did not orbit around the earth. What we are discovering today is that this industry does not orbit around the New York Stock Exchange.

While the earth seems to be the only planet habitable for human life, the securities industry can operate from anywhere. This is the significance of the electronic technology now developing within our industry. This is also the significance of the SEC's recent statement on market structure which calls for the development of a national central market system for listed stocks. This is the significance of NASDAQ with its ability to centralize market information from all sections of the country. The creation of a national central market system for listed stocks will accelerate the trend toward coordinated, regionally based markets in every type of security. There is no reason today why the market for a security, the execution of an order, the clearing, the transferring, and the safekeeping of every security—whether listed or unlisted—cannot take place in the city or region where the order originated.

In this central market system you will be able to execute your orders in California when the markets are as good as those elsewhere, and even more importantly, you will attract orders from the rest of the country when your markets are better than those elsewhere.

For the first time markets outside of New York will have an equal chance to vie for the position of being the primary market in a listed stock.

How do we get there? The consolidated tape is the first step. The new tape will be an equal opportunity tape. It will no longer be necessary to send orders to the floor of the NYSE merely to get the seal of approval of a tape print. A consolidated tape should be structured to give Pacific Coast transactions and those on other markets the same publicity and imprimatur NYSE trades receive today.

Actually, competition exists today for the NYSE specialist. The only thing inhibiting the development of this competition is that too many people are not aware of its existence. A common tape and a common quotations system will remedy that information gap and allow all markets to compete solely on their ability and their willingness to do so.

As we adjust our thinking, myths are often shattered. One such myth is that somehow the NYSE has the exclusive right to provide a market for stocks listed on their exchange. This myth is perpetuated daily in the financial pages as trading volume and prices are reported in these stocks in tables showing "New York Stock Exchange" emblazened across the top. With the consolidated reporting of all trades in listed stocks, the reality of multiple, competing markets, all having the same right to provide a market for these stocks, will replace the myth.

The competition existing today is there in spite of the NYSE's concerted efforts to eliminate it. Once we break the image of a securities universe orbiting around the NYSE, we break the image of the NYSE as the only primary market. When this is done and the capital, experience and willingness—already available in many regions—develops, the primary market can, and will, shift in every stock, everyday, with every market having equal claim to that description. Once our thinking is freed, little more is needed to imagine the potential opportunities for the securities industry here in Los Angeles and other areas outside of New York.

Irrespective of the public interest veneer that's placed on the

NYSE's actions, I think it's clear that NYSE policy is dominated by their desire to protect the interests of their floor—their specialists, their floor traders and their floor brokers—and to keep the orders from all over the country automatically flowing to them.

From your point of view, whether you are NYSE members or not, this is of no concern to you. All of you will receive the same commission on your orders whether they are executed here in California or anywhere else. It shouldn't be necessary for me to itemize the savings you realize when you do your business locally—savings in unnecessary floor brokerage costs, which are high in New York relative to those on regional exchanges; unnecessary clearing costs, which are high in New York relative to those on regional exchanges; unnecessary communications costs; even the unnecessary New York office which was originally required because the business had to be executed and cleared in New York.

The costs of doing business in New York can be staggering. Correspondents of New York based firms have to allocate some 20 to 30% of their commissions to New York based firms for execution and clearance. Now, with the introduction of competitive commission rates, these correspondent costs place regional firms at an increasingly greater competitive disadvantage to their New York based brethren. A central market system will make it possible to do more of that business regionally, retain greater control of the orders executed elsewhere, and settle *all* transactions regionally, irrespective of where they were done. What I am talking about is dollars on the bottom line; it is redressing the balance of payments deficit that has existed for too long between Los Angeles and New York.

Let's talk about clearance for a moment. The leadership in developing improved clearance systems has come from the regional exchanges and the NASD. It was the Pacific Coast Stock Exchange which developed the continuous net clearing system—a system which served as the model for the NASD's National Clearing Corporation. It is a system that can readily be the nationwide clearing system for this industry. The Pacific Coast Clearing Corporation could become the West Coast depository in the NCC system. Thus, if you have a trade with someone in Boston, you would settle with the clearing corporation here, the fellow in Boston settles with the clearing corporation there and the system would take care of the rest. The potential cost savings are enormous. The NCC's continuous net clearing system is the one system that is oriented toward regional centers; it is the one system that encourages and facilitates market making outside of New York; and it is the one system whose sponsorship is not biased toward New York.

In the area of clearing, this industry is beginning to move closer together. How it ultimately comes together is of great importance. Will it be brought together in a manner that recognizes the equality of the many regional centers or will it be coerced together in a manner that discriminates in favor of New York? There is an effort underway to force it into the control of the NYSE-Amex-SIAC complex. This route, in my view, will perpetuate the NYSE's domination of our business and stifle the natural development of the industry outward toward the regions where the orders originate.

I believe that a single, national clearing system would be a significant step in unifying this industry. However, I don't believe that such a system should be created at the permanent exclusion of a better one being developed outside it and replacing it. The mere fact that a substantial investment has been made in one system should not be the sole reason to justify its continued existence if better, less costly alternatives become available. This applies to trading and communications systems as well as clearing systems.

Our country has grown and prospered because we have encouraged innovation and competition. These are the safeguards which keep economic rigor mortis from setting in. In our industry these safety valves have been provided by the regional stock exchanges, the third market and increasingly by the NASD. Without them there would have been little progress.

The purpose of this industry is to provide an efficient and responsible marketplace for securities and to raise capital—it has never been to preserve the New York Stock Exchange. It's essential that any new market structure not seal itself off from future innovation and competition.

Now that the NYSE has accepted, at least in principle, the fact that a central market system is a communications system, its buzz words have changed. We no longer hear any talk about the "fragmentation of the central market." The current sermons are on "equal regulation." "Sure competition is good, but it must be competition under equal regulation." Translated this means other markets must accept all the rules and regulations of the two New York exchanges as a package, irrespective of whether they are necessary for the public interest. At its most ridiculous extreme, equal regulation means that competing markets can talk to anyone, anywhere, so long as they don't use telephones, wear beige jackets and don't allow women on their floor.

The Exchange's demand for equal regulation is as misleading as was their concern over fragmentation and equally destructive to the purpose of developing a central market system.

As far as I know, no one is against equal regulation that is necessary to protect the public interest. But, just what is necessary to achieve this goal has still to be determined. A central market system containing many market makers in competition with one another is an entirely different structure than one with a monopoly franchise as its center. Whether more, less, or the same regulation will be required can only be determined after we gain practical experience. In the past the SEC has accepted different levels of regulation and may find them just as appropriate under a new system. What is necessary now is to take the first step toward a more centralized system by means of a consolidated tape and quotations system rather than cry wolf each time a positive step forward can be made.

I really don't intend to sound so anti-NYSE. They are simply looking after their own economic interests. This is understandable. They want to protect their investment in their trading and clearing systems. This is also understandable. Yet, these interests are not necessarily your interests and that should be clearly understood.

Because of its size and economic leverage, the NYSE has, in the past, been the primary source of leadership in this industry. This situation has changed dramatically in recent years, in large part because the NYSE has not been responsive to the industry's needs. There is a growing recognition that the NYSE speaks for only a special segment of the industry. It is this fact combined with the Exchange's inability to provide positive, innovative leadership which has caused this industry to look beyond the NYSE for direction. One effort at providing leadership is being made by the Securities Industry Association. However, I'm skeptical that the SIA, as presently structured, can fill that role. First of all, the SIA has chosen to represent only the larger firms in the industry. I think this decision is unfortunate and short-sighted. Its other weakness is its built-in orientation toward the New York Stock Exchange. Despite the fact that the SIA includes non-New York members firms, it still basically represents the interests of the NYSE through its domination by those "upstairs" members who are New York oriented. This includes the regional firms who have adjusted to New York as the center of the industry. This NYSE bias is clearly reflected in the SIA's ambivalent stand on the question of which of the various clearing systems is best for this industry. Under a regionalized structure such as NCC's, it would not be any more necessary for a G. H. Walker & Co. to have a New York clearing operation than for a First National Bank in St. Louis to have one. If the SIA desires to truly represent our industry, it will have to broaden its constituency and become more regionally oriented.

There should be no mystique surrounding the changes taking place. The essential features of the marketplace will remain the same, only now it will have more geographically dispersed markets connected by a common tape, a common quotations system and a common clearing system. It's a natural and logical evolution toward greater simplicity and efficiency in this business. In time, it will give everyone the opportunity to be at the center of the securities universe.