A Stock Trading System for the Future

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"The time to stop a revolution is at the beginning, not the end." The New York Stock Exchange would have done well to heed Adlai Stevenson's advice when he gave it back in 1952. Back in 1952, when institutional investors were first emerging as the dominant force in the securities industry, the Stock Exchange might have saved its floor as the exclusive market had it elected to make the necessary reforms.

By 1972, it is too late. Competition has moved in. Listed stocks are now regularly traded in substantial volumes in many competing markets – the New York Stock Exchange, the Regional Exchanges, and the Third Market. The Exchange pursues a myth when it speaks of a sacred, single auction market to which all orders must be sent. It is a myth exposed by today's technology.

At one time, of course, the only practical method of centralizing buying and selling inquiry was through a single market – the stock exchange trading floor. The system worked reasonably well, because the flow of small orders of private investors resulted in small imbalances and thus, relatively little dealer participation was needed. But then came the institutional investors with their block trades, which were simply too much for the exchange floor to handle. Moreover, institutional investors were sophisticated about the true costs of execution. They demanded – and got – rebates on the commissions they generated and they went to other markets to get maximum depth and liquidity. The rebate abuses of the Exchange's fixed commission schedule, plus the growth of the Third Market and Regional Exchanges, ended New York's monopoly grip.

Actually, the Exchange's monopoly was bound to crack because on the Floor the important role of market making was not opened to competition but was, and still is, allocated as a monopoly franchise. Specialists cannot deal directly with the institutional buyers and sellers. They are forced to fly blind and so, have turned timid. Finally, access to the Exchange was, and is, limited to a fixed number of members through whom all non-members must deal at unnaturally high rates. The New

York Stock Exchange views the competition of the Third Market and Regional Exchanges as fragmentation of their self-styled "central market". Old leadership, unaware of the realities, fails to recognize that the cause of this fragmentation is their efforts to preserve an economically burdensome monopoly.

Technological developments during the past decade have eliminated the question of a single geographic central market vs. competing markets. Today we can have both – separated, competing markets connected into a central market system. New York, the Regionals and the Third Market can and must compete with each other. The inescapable logic of today's technology has changed the central market from a piece of real estate at Wall and Broad Streets to a nationwide communications system.

That is what competition did, and now the Congress and the Administration intend to make it permanent. The Securities and Exchange Commission has issued a statement called the Future Structure of the Securities Markets. This statement followed several months of extensive public hearings on the subject. The Commission called for the development of a central market system with open access by all qualified brokers and market-makers. A central market system is defined as "a system of communications by which the various elements of the marketplace, be they exchanges or over-the-counter markets, are tied together."

Back in the Spring of 1971, the Securities and Exchange Commission, in a letter to the Congress, transmitting its Institutional Investor Study Report, stated that "[T]he evolution of the securities markets has been . . . distorted by barriers to competition. Among the most significant of these are minimum commission rates and rules that insulate markets, market makers and broker-dealers from each other."

By 1972, practically everyone in the securities industry accepts the view of a central market as a communications concept – even the New York Stock Exchange. The ingredients are fairly simple: competing markets and market makers; a consolidated tape; a common quotation system; competitively set commission rates; and open access. Competing markets and market makers hooked into a nationwide communications system reporting transactions and quotations equals a central market. There is no place, *de jure* or *de facto*, in such a system for monopoly privileges.

Today, the major issue facing the securities industry has been restated. The issue now is who controls the communications equipment for the central market and who has access to it. The precise structure and operation of such a system cannot, nor should not be pre-determined for eternity. What must be done is to eliminate those barriers which keep a central market system from developing in a natural and efficient manner, and to ensure that whatever form a future structure takes is consistent with the public interest.

For example, one of the major requirements which has developed in the securities market is the need for more market making — dealers willing to buy when all others want to sell, and the other way around. This need intensified as a result of the enormous increases in trading volume and more particularly, trading imbalances, experienced during the sixties. These imbalances were created by increased volume for all sized trades — small, as well as large institutional transactions.

There is no need — certainly not any public need — to limit competition in market making. There is also no need to restrict, artificially, trading in any security only to exchange markets. The New York Stock Exchange recently endorsed the central market approach, but tried to restrict it to stock exchanges only, thereby excluding all non-member dealers who wished to make markets. They were like the maiden willing to be only a little bit pregnant. The clear fact is that the technology necessary to connect New York and Regional Exchange markets for the operation of a central market system is identical to that necessary to connect the New York, Regionals, and the Third Market.

The competition in market making we now have operates imperfectly *vis a vis* the NYSE market maker — the specialist. It is thus essential to provide equal competitive opportunities

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for all existing market makers and for those willing and able to become market makers, provided such opportunities exist. Communications technology is the answer.

The first technological steps are to eliminate the information barriers in the market by disclosing all prices and quotations on a comparable basis. One step is the consolidated tape. This tape will report all trades on all Exchanges and in the Third Market within one minute after their completion, in the same manner in which only NYSE transactions are reported today.

Until recently it appeared out of the question that industry agreement could be reached on this important innovation. Yet, after extensive discussions, agreement has been reached. This tape should be in operation by the latter half of next year. In addition to providing more disclosure about the market, the tape is important for the competitive opportunities it provides. Prices of NYSE specialist trades will no longer be set in isolation from, and thus without reference to, prices on other markets.

consolidated ↔

The tape shows what happened in the market. The other step — a common quotation system — shows what can be done, and where. This system will display bids and offers of all markets and market makers on a television screen. It will be available to the industry and the public, to better determine where the best price can be received. We know an automated quote system can work — in fact, such a system exists today, primarily for non-exchange listed securities. It is known as NASDAQ — an acronym for National Association of Securities Dealers Automated Quotations. There is no functional reason why this system could not display all quotes in listed stocks as well. The Third Market is doing that today in some eighty-five stocks. Computers are apersonal and cannot differentiate between listed and unlisted securities — unless artificially programmed to do so. No technical reason exists which should prevent a common quote system from becoming a reality next year. This system could — with little difficulty — also show the share size of bids and offers, as well as indications of larger buying and selling interests near the published quote.

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There is one feature which should be incorporated in a future market structure. This is the capability to give all publicly recorded bids and offers of individual investors priority over those of market makers. This can be done by establishing a public book as part of a common quote system. With this capability, a future market will provide the maximum opportunity for public orders to meet directly in a market which allows for maximum market maker competition. This resolves the conflict between an auction market and a dealer market, by giving priority to small public orders.

With the elimination of information barriers, there must follow the elimination of economic barriers. The two most significant barriers are fixed commission rates and limited access by all brokers to all markets.

The New York Stock Exchange's efforts to preserve fixed rates brought its member brokers close to the labyrinth of public utility-type regulation. Under such regulation, profits become a matter of good politics rather than good business. Though tempting, that dangerous route appears to have been avoided. More and more, Exchange member firms now realize that the *quid pro quo* of the continuation of fixed commissions is eventual governmental regulation of profits. In 1971, the industry began experimenting with competitive rates for large orders. The dire predicted consequences have not materialized. It should not be too long before such rates are competitively determined for all sized trades.

Finally, with competitive rates there must be open access. There is no reason why all qualified brokers in the industry should have to pay arbitrarily high entrance fees to a private membership club to have access to a market place. Nor should the Exchange try to protect its floor by prohibiting its member brokers from getting better executions in other markets. Without open access to all markets, a market in which brokers can properly fulfill their fiduciary obligations cannot exist.

In the evolution toward a central market system, form will follow function. From a consolidated tape and a common quote

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system the communications links and the degree to which automation can be used directly in the trading process can best be determined. Automated executions are clearly feasible for small round-lot transactions. As trade size increases and more brokerage and market making judgment becomes necessary, automation will serve more as an information tool than as an order matcher.

The securities industry must never be closed to new ideas and innovation. Opportunities must always exist for experimenting with new automated trading and communications systems. One such development which should be of particular interest to Britain's securities industry is ARIEL. This exciting, new communications system permits transactions to be negotiated, completed, and confirmed — and, perhaps, even eventually cleared — directly through the system.

The potentials of automation in the processing and clearance of securities transactions are perhaps even greater than those in trading. Once transactions are completed, it should be possible to immediately start processing those trades in a national clearing system, thereby eliminating much of the unnecessary physical movement of certificates occurring today.

The purpose of today's technology should be to simplify the way the securities business operates. It should not be misused to institutionalize outdated ways of doing business in fancy new packages.

Revolutions seldom go backward. The days of privilege and protectionism in the securities industry are ending. Free competition and full disclosure, enhanced by maximum use of technology will develop the market of the future.