Statement by

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before the

SECURITIES AND EXCHANGE COMMISSION

Hearing on Stock Exchange Commission Rate Structure

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I am Donald E. Weeden, Vice President of Weeden & Co. in charge of its Stock Trading Division.

Weeden & Co. has asked to testify in response to the Securities and Exchange Commission's Release No. 8328 dated June 5, 1968 and specifically with regard to the following topics noted in that release: (V) economic access to exchange markets by non-member broker dealers, (VI) competition among exchanges and among exchanges and other markets and (VII) the necessity for restrictions on access of exchange members to the Third Market.

As background to my testimony I would first like to describe Weeden & Co., and the extent of our trading activity, and also make some observations on the differing role played by the dealer and the broker in the securities markets.

Weeden & Co. is a public corporation with 428 stockholders, with capital as of September 30, 1968 of about $19,000,000 and with six domestic offices and one overseas office. We employ approximately 400 people. Our customers are almost exclusively financial institutions, such as banks, or insurance companies, or other broker dealers. Our chief business is trading securities. We act as a market maker in general market tax exempt bonds and notes, tax exempt dollar quoted revenue bonds, and approximately 250 common stocks, most of which are listed on the New York Stock Exchange and one or more of the regional exchanges. Our role as market maker in listed common stocks includes us in what the Commission, in its Special Study, has termed the Third Market. This role is recognized by the Commission and the NYSE through our satisfaction of the requirements of a market maker as defined in their rules 17a9 and 394b, respectively.

We utilize our capital to finance and carry our trading positions. In the first nine months of 1968 our overall average overnight exposure (long plus short positions) amounted to $85,247,000. Our average overnight exposure in Third Market securities was $29,329,000. As a means of comparison, this exposure in stock positions is almost three times the average

overnight exposure of all specialists on the Pacific Coast Stock Exchange in 1967 as reported in a recent letter to the Commission. Our overall sales volume in the first nine months of 1968 amounted to $2,854,603,000, of which Third Market securities accounted for $1,602,022,000. This means that we "turned" or sold our average overall inventory approximately every 5.3 working days and that we turned our Third Market inventory every 3.2 working days during the first nine months of 1968. In the same period our average transaction in Third Market securities was 254 shares. We make legitimate and constant markets in Third Market securities and do not, as some may believe, trade only in occasional blocks or move in and out of market making as the whim moves us.

We stress our role as a dealer and as a market maker and positioner of securities because it is important for purposes of this discussion to keep in mind the substantial difference between a broker and a dealer. A broker acts as agent and represents the buyer or seller in the marketplace. Ownership of the securities bought or sold is never vested in the broker, so that the breadth or liquidity of the marketplace does not directly result from his actions.

A dealer, on the other hand, buys or sells for his own account and risk, which means that he contributes his capital resources to the securities transaction. His profit, or loss, is dependent upon the difference between the price at which he buys and the price at which he sells. The underwriter, the over-the-counter trader, the Third Market maker and the specialist on the exchange are all dealers performing the same essential function of risking their capital. To the extent that the breadth and liquidity of markets is measured by the ability of the marketplace to absorb large temporary imbalances in supply and demand without major price adjustments, to that extent it is the willingness of the dealer to position these imbalances that gives the markets their breadth and liquidity. The dealer acts as a shock absorber to cushion the effects of a large supply for sale when immediate buying is not available to absorb that supply and vice versa. In discussing the differing functions of the dealer and the broker, it should be pointed out that a stock exchange is not a homogeneous organization but rather has dealer members or specialists whose interests, functions and responsibilities are quite different from those of the broker member who solicits and transmits the buy or sell order to the floor for execution.

With these simple points as background we can proceed to a discussion of the specific matters raised by the Commission in its Release No. 8328.

Economic Access to Exchange Markets by Non-Member Broker Dealers

Weeden & Co. has no interest in joining the New York Stock Exchange even if it were permitted, as a public corporation, to do so. Nor do we have any interest in joining any of the regional exchanges. We do not, in the normal course of our business, act as a broker. Thus, exchange membership would be inconsistent with our dealer function as an independent, alternate, competing market for those listed shares we trade and would be of little use to us.

When we hire a broker as our agent to transact business on an exchange, which we occasionally do, we pay the full public commission. We see no justification in our asking for or expecting a percentage rebate on the full commission simply because we are an NASD member in good standing. We think exchange brokers have a right to whatever exclusiveness they can legally derive from their membership on an exchange. If we were a broker and wanted commission income of this sort, we would feel obligated to join the exchange, pay its fees, and subject ourselves to its regulations and supervision. Others in the securities industry and in government undoubtedly feel differently on this point. However, we suggest to the Commission that any step requiring NYSE members to share commissions with originating NASD broker-dealers who are not NYSE members might result in the formation of a plethora of broker-dealer firms by quick witted members of the public and by institutions solely to take advantage of these rebates. We doubt this would be in the public interest. The problem is not to cheapen the value of exchange membership, but rather to make it more responsive and responsible to the industry's needs.

Competition Among Exchanges and Among Exchanges and Other Markets

Weeden & Co. believes that the public investor, the institutional investor and the public interest can best be served by fully competitive and independent market makers. Competition among exchanges has produced positive change in the marketplace and we feel that the Third Market, a competitive market away from the exchange community of interests, has added its own pressure for evolutionary improvement in the market making machinery. We believe that the trend towards greater institutionalization of the equities market increases the need for multiple and competitive markets in a given security.

Institutions dealing in securities tend to trade in larger amounts than individuals. Institutions usually demand quick execution of their orders to buy or sell large blocks of securities. These characteristics of institutional trading – large volume, high speed executions – result more often than not in supply-demand imbalances, and make necessary substantial position taking ability in the marketplace. These requirements seem best met by a so-called negotiated market of many position-taking dealers or market makers than by an auction market with its inherent requirement that buy and sell orders be fairly evenly matched if it is to work smoothly.

Thus, as institutions succeeded individuals as the major buyers of U.S. Government and Corporate Bonds in the 1920's and 1930's, the marketplaces for these securities changed from auction markets to negotiated markets. Today the institution or broker entering these markets to buy or sell can deal with from 10 to 20 positioning market makers who bid for his business on a competitive basis. To some degree this is true in all negotiated security markets which would include all tax exempts and the OTC stock market.

The continued and dramatic growth of institutional investment in the equity markets following World War II has resulted in more and more block trades being transacted. The supply-demand imbalances created by the block business has put strains on the auction markets, requiring even greater involvement by the specialists in position taking. The exchange specialists, some of whom have relatively small capital and all of whom enjoy a monopoly position within the exchange, sometimes have permitted greater price swings in the auction market than the seller or buyer or his broker felt was justified under the circumstances.

It is in the soil of this discontent with the auction market that the Third Market has flourished outside the exchanges and that lately the practice of position taking by brokers within the exchanges has grown. The former gives the institution an alternative to the specialists market away from the exchange and the latter an alternative within the exchange. If the auction market functioned well under all circumstances, these alternatives would not be necessary.

In its entirety, the Third Market today equals less than 4% of NYSE volume, a very minor share of the market. Yet we feel that its competitive influence has been considerable, vis-a-vis, the prior monopolistic position of the specialist. The cost of a transaction on an exchange to a buyer or

seller is not just the commission but the price at which the trade is consummated. To the extent that competition with the Third Market has resulted in better execution costs to the public, then this competition is of overall benefit to the marketplace. We believe that this is the case, and that it is in the public interest to maintain and enhance this competition, not limit or destroy it.

The NYSE response to the Third Market has been to warn of the fragmentation of the auction market, to urge that all business be funneled through that exchange lest the overall market lose breadth and liquidity and to take steps inhibiting its members from dealing with the Third Market. The NYSE's argument that fragmentation will lead to greater price swings is certainly weakened by the price stability of those listed utility stocks where off-board trading constitutes a large percentage of total trading in the stocks. At any rate, whatever validity these arguments possess applies only to the auction market when it is a true auction market. So long as all orders are for 100, 200 or even 500 shares, and are reasonably balanced as between buy and sell orders, then an auction market works well and is enhanced by greater volume. But when blocks come in and imbalance the auction, the system tends to break down and what results inevitably is no longer an auction market but a negotiated one which requires position takers and capital funds to carry the positions generated. The Third Market adds $100,000,000 in position taking capability to the equity market. Far from fragmenting the market, the injection of this capital gives the overall market much greater stability and depth. From this standpoint also, the preservation of the Third Market as a competitive force is of benefit to the public and to the overall market for securities.

The Necessity for Restrictions on Access of Exchange Members to the Third Market

We believe that any restriction placed upon a broker's free access to a legitimate market for a security in which he is dealing limits that broker's ability to exercise his fiduciary responsibility and, further; creates an unnatural fragmentation of the overall market for that security. The loss of fiduciary responsibility and the degree of market fragmentation increase with the size of the impediment placed between the broker and marketplace. Weeden & Co. is advocating a revision of NYSE Rule 394(b). In doing so we are not requesting privileged access to the floor of the NYSE,

but rather, we are suggesting that the NYSE cannot defend a continued restriction of access by their broker members to the Third Market.

Rule 394 of the NYSE forbids a member firm to effect a transaction in a listed stock off the NYSE floor either as principal or agent, except with permission of the NYSE. The Rule is of relatively recent origin; and in the opinion of those who have studied the matter both in the industry and in the Commission, is the result of the competitive pressures exerted by the Third Market and the regional exchanges responding to the demands of informed institutional business. In 1966, under pressure from the Commission, the NYSE adopted an amendment to Rule 394 in the form of 394(b) which purportedly was designed to provide access under certain conditions to the Third Market by NYSE members.

The Third Market and many New York Stock Exchange brokers have made a determined effort to make Rule 394(b) work. Weeden & Co. has responded with 128 competitive bids or offerings to the 131 inquiries made to it since the rule was implemented. Of these responses, 114 or 89% were an improvement over the price on the floor, although for various reasons only 65 of the responses resulted in an actual trade.

Despite this success, however, inquiries to us have become fewer and fewer until now they are at the rate of only one or two a month. The reason for this falling off in inquiries, we are convinced, is because compliance with the provisions of the rule is too complicated and too time consuming to make it workable. Rule 394(b) requires the following ponderous procedure:

(1) The member seeking to go the Third Market on a particular transaction must satisfy a floor governor of the NYSE that he "has used due diligence and explored every avenue in order to obtain a satisfactory execution on the floor";

(2) The floor governor must then "discuss the proposed off-floor trade with the member handling the order and with the specialist who handles the stock in the Crowd";

(3) "If the member still desires to solicit a non-member market-maker after all possible avenues for a satisfactory execution on the floor have been explored", he fills in a form more complex than any form regularly used in the securities business;

(4) The floor governor then reviews this form and signs it, noting

that his signature "in no way should be construed as giving approval to the off-floor trade";

(5) The Third Market-maker's firm bid or offer then "must be taken back to the Floor where it may be replaced by other bids or offers on the Floor"; and

(6) "After the off-floor transaction has been completed, the floor broker who handled the order should promptly contact the post supervisor and complete the second part of the form."

(Quotations are from a Memorandum to all Floor Governors re Amendment to Rule 394, November 1, 1966)

Small wonder that little use has been made of the Third Market by members of the NYSE.

Rule 394(b) in its present form is in the nature of an hypocrisy. Purportedly it creates the ability on the part of a member broker to secure a better price for his client in the event that the bid or offering from the floor specialist is not competitive. In practice it is almost totally unworkable. Its existence, however, permits the New York Stock Exchange to claim complete fulfillment by its members of their responsibility as brokers to get the best possible price for their customers. We believe Rule 394(b) should be amended in order to make it operable or else it should be eliminated entirely.

We would much prefer that Rule 394(b) be amended so that trading under its provisions can be simple, swift and relatively easy. Our reasons for suggesting this to the Commission can be summarized under four points:

(1) When handling blocks of stock for customers, many NYSE brokers would prefer to have an easy alternative to what they might consider an uncompetitive bid or offering from the specialist. These brokers apparently feel strongly their obligation as agents to get the best possible price for their customer. They also resent, at times, losing their client either directly to the Third Market, or to another broker who is unrestricted in his approach to the Third Market.

(2) There is a fiduciary obligation on the part of a broker to get the best possible price for his customer, whether or not it is necessary to go off the NYSE floor in order to achieve that result. In the *Edison Electric* case, 1 SEC 909 (1936), the Commission stated:

"(A) well-governed exchange recognizes limits to its operations as an automatic auction market . . . (It) should . . . recognize and enforce

the duty of the broker to get the best price for his client, even though that price is only obtainable off the floor of the Exchange . . ."

(3) We repeat our argument that in the case of block transactions that would be taken to the Third Market, the auction market is obviously not functioning well. If it were there would be no compelling need to seek competitive bids or offerings. Under these circumstances, the Third Market capital tends to supplement that of the exchange specialist and adds stability and liquidity to the overall market. There is no fragmentation of the auction market because the auction market sees the block first. The Stock Exchange has said that "a knowledgeable broker is well aware of what a satisfactory price for his order ought to be, based on the size of his order, the particular stock and the current market". If this is true, and we believe it is, there is no excuse for the NYSE to erect cumbersome machinery that makes it difficult for a broker to get a competitive bid or offer when his instincts tell him one is necessary.

(4) We further believe that there are anti-trust implications for the NYSE in its prevention of its members from dealing freely in the Third Market. It is quite clear from In Re Rules of New York Stock Exchange, 10 SEC 270, 283-284, 287-288 (1941), the so-called *Multiple Trading* case, that previous attempts by the NYSE to forbid its membership from dealing in other markets have been struck down by the Commission. In that case, the question was whether NYSE members could be precluded from dealing on regional exchanges in dually listed stocks. Holding that "the Rule discriminates against those members of the NYSE who engage in dual trading", the Commission concluded that the Rule must be revoked because it "constituted unfair administration by the NYSE (and) . . . is at best . . . an attempt by the NYSE to implement its minimum commission rule". (ibid 292) In reaching that conclusion, the Commission noted that the regional exchanges provided necessary competition and depth to the NYSE market.

What possible difference is there between the right and justice of a member of the NYSE being able to deal on a regional exchange in a dually listed stock and the right and justice of the same member being able to deal with the Third Market in the same security? The action of the NYSE in forbidding its members to deal with the Third Market, except with NYSE approval, is in our opinion a concerted boycott which is illegal and unwise.

The type of revised Rule 394(b) that we envision is a very simple one. A broker with an order who is dissatisfied with the bid or offer or indication he receives from the Floor should be able to take that block immediately to the Third Market for a competitive bid or offer and to trade the block in the Third Market if the bid or offer he receives there is better than that of the Floor. He should be able to do this without prior approval of a governor of the Exchange. We would anticipate that the NYSE would require the broker to file a report of his off board trade with the Exchange, but only after the fact. We would not object if the trade were printed on the Stock Exchange tape. We further would not object if the rule should make implicit in any off board trade the requirement that the specialist's book be satisfied down to the price of the sale by the broker or up to the price of a purchase by the broker.

We suggest that the requirements for designation as a market maker in the Third Market by the Commission be as strict as the Commission feels necessary in terms of capital and market making activity.

Quite clearly there is enough historical precedent and community interest to insure that the vast bulk of listed transactions will continue to be handled by member firms on the NYSE floor. We therefore see no need to place an artificial restraint on those brokers who, in response to economic opportunity and their fiduciary duty, wish to seek bids or offers from qualified Third Market makers.

Rule 394(b) should be changed.