

Reprint of a Letter Submitted
to the
SECURITIES AND EXCHANGE COMMISSION

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Gentlemen:

The securities industry, buffeted by change, faces a less than certain future. Many of the problems and conflicts confronting the industry are either presently before the Securities and Exchange Commission for decision or soon will be. The final disposition of these problems and conflicts will determine the shape of the industry for years to come.

We write the Commission as a major Third Market firm in order to expose a particular point of view concerning the issues before it. In PART I we discuss factors bearing on the future structure of the industry with special emphasis on the concept of a Central Market Place. In PART II we answer some of the charges recently directed at the Third Market by representatives of the New York Stock Exchange. In PART III we urge on the Commission a specific course of action.

PART I

Considerable restructuring of the securities industry must inevitably take place in the next few years. The forces compelling this change stem largely from the overwhelming increase in institutional business in common stocks acting upon archaic and inflexible rules maintained by the industry's principal stock exchange.

The resulting pressures have already brought about the growth of the Third Market, the advent of member firm block positioners and demands for public ownership of member firms to meet the increased capital needs of the Street. Increased institutional participation in the market place has raised the following important issues:

1. An equitable stock exchange commission structure; or whether minimum commissions in some instances are necessary.
2. Institutional ownership of stock exchange firms.
3. Institutional access to the exchange markets.
4. Access of non-member dealers to the exchange markets.
5. Access of member firms to off board markets.

The hard truth is that the economic interests of the institutional investor are better served by a negotiated market than by an auction market. The institutional investor prefers to control his own order; he wants direct access to the market makers; and under normal conditions he would rather avoid paying an unnecessary commission to a broker interpositioned between himself and the market maker.

The increase in institutional block business has drastically reduced the effectiveness of the specialist, not so much because the specialist lacks capital resources, but because he has lost contact with the market. The large ticket market has increasingly moved off the floor of the Exchange. Because New York Stock Exchange rules preclude the specialist from dealing directly with the public, he has found it impossible to obtain direct exposure to the full sweep of institutional inquiry. Consequently, he is flying blind and is understandably unwilling to risk his capital on large positions.

Into this vacuum has come first the Third Market, and more recently the member firm block positioners. Both groups have more access to the ultimate buyers than the specialists. The transition would have come earlier and with more dramatic suddenness were it not for the convenient uses that many institutions find for commissions in paying for research, rewarding depositors, and in the case of mutual fund management companies, repaying efforts by dealers to sell their fund shares.

The New York Stock Exchange's persistence in perpetuating the monopolistic position of its specialists, in fostering its members' isolation from other market places, and particularly in maintaining a commission structure for block business that greatly exceeds the cost of executing and processing that business, has resulted in tortuous distortions in the securities industry. The Commission Rate Hearing disclosed the elaborate and devious methods by which institutions are rebated commissions and fiduciaries use commissions generated on funds for which they are responsible to discharge their own obligations to others. We have witnessed institutions entering the securities business as broker-dealers with no other purpose than to reduce their commission charges. We have seen the New York Stock Exchange promulgate rules that would permit its members to sell stock to the public, while at the same time prohibit to institutional customers the right of membership; and we have noted with interest the Justice Department's reaction to these proposed rules. We have observed New York Stock Exchange members long identified as brokers being forced to take up the burdens of a dealer solely because the specialist system is not equipped to handle the

large imbalances of institutionalized markets. We question whether the inherent conflict of interest between acting as broker and dealer in the same transaction is healthy for our industry. We submit that such distortions and others in our industry are at least in part the result of New York Stock Exchange practices. Continuation of these practices in the New York Stock Exchange version of a "Central Market Place" would, in our opinion, simply exacerbate the distortions and reinforce the devious devices related to them.

The Central Market Place Concept

We are not opposed to the Central Market Place Concept. We give it our wholehearted support. However, the N.Y.S.E. version of the Central Market Place is truncated and self-serving. By building a wall around its own special privilege, the Exchange has kept out the capital, the inquiry, and the participation of other market makers, and restricted its own members from seeking better markets away. The result is that the N.Y.S.E. is itself fracturing the Central Market Place.

The Central Market Place today is no longer a geographical concept. It is a communications concept. With today's electronic miracles available to the industry, all market makers wherever located could be combined into a central, interrelated market for fast and efficient access by investors to all of its segments. The true Central Market Place demands access to all available pools of positioning capital for maximum liquidity.

The New York Stock Exchange would have the Commission assist it in blocking this development of the Central Market Place. The Exchange's response to the massive need for more liquidity is to speak of supplementing scarce specialist capital by permitting partnerships with positioning brokers—a short-term expedient which, in our opinion, involves conflict of interest between the broker function and the dealer function. Were such partnerships permitted, Exchange rules would still make it difficult for a member broker to deal with outside market makers. Thus, a broker would be forced to deal with a competing broker acting, in this case, in partnership with a monopolistic specialist. Once again the Central Market Place is fractured by the New York Stock Exchange.

The New York Stock Exchange claims that its restrictive version of the Central Market Place protects the investor and, therefore, is a justified restraint of trade. While history and common sense rule that full and free competition best protects the investor, or any consumer for that matter, the Rules of the New York Stock Exchange say no. Specialist posts have

long since been non-competitive on the floor of the Exchange; and the Special Study in 1963 stated that a return to competition in this regard was a practical impossibility. The Minimum Commission Structure and Rule 394, once stated to be the cornerstones of the New York Stock Exchange by its President, also restrain competition. Nothing in the New York Stock Exchange testimony at the Commission Rate Hearing, in its present proposals before the Commission, or in the anticipated content of future proposals, indicates anything but a continuation of policy directed towards reducing competition from other market makers and regional exchanges. For these reasons, we believe the New York Stock Exchange, not its competition, is fracturing the Central Market Place.

The New York Stock Exchange claims, as an important strength in its version of the Central Market Place, that, for better or worse, all inquiry is centered now in one place. A careful reading of the Commission Rate Hearing belies that claim. Testimony by the Chairman of the Board of Governors of the New York Stock Exchange with regard to block trades shows clearly that the specialist is often the last person shown a block inquiry from an institution, and many times is never exposed to it at all.

The Central Market Place will come to exist through freedom of access, not elimination of competing markets. There is no reason why all inquiry in listed stocks cannot be centered in an up-to-date version of the Central Market Place, involving computers and electronic display panels such as envisioned in the NASDAQ system. Such a system could be enhanced by a "public" ticker tape capable of reporting trades in all market places, including all exchanges, on a real time basis.

We reiterate that the present New York Stock Exchange proposals before the Commission and everything we hear rumored about its forthcoming proposals lead us to the conclusion that the New York Stock Exchange is attempting to maintain the present barriers between itself and the competitive forces in other areas of the industry, with the calculated hope that it will be more difficult for these competitive forces to survive. We believe that much of what the Exchange is doing and proposes to do is illegal under the anti-trust laws. We also believe that what the Exchange is trying to do will be extremely harmful in the long run to the entire industry.

Left to their own devices, without concerted action by the New York Stock Exchange, markets in listed stocks should logically evolve into a simple combination of the present auction market servicing broker-handled executions of public orders and a negotiated market of well-capitalized

market makers catering mainly to institutions. This is the direction that the corporate bond market took in the 1930's and 1940's when increased institutional trading in those securities demanded something more than just an auction market. What evolved was a combination market place that preserved the auction market while at the same time encouraged the growth of market makers, both inside and outside the exchange structure. This system protected the individual investor and the brokerage function related to that type of business, yet was capable of providing the liquidity and depth necessary for expanded institutional trading.

We believe the market in institutional grade listed stocks will evolve into something quite similar. The extent of that evolution will depend largely on the balance that is struck between the participation of the individual investor and the institution in the ownership of such stocks. If, as we are told, "stocks are merchandised, not bought," an important determinant of this balance will be the level of commissions charged on small transactions relative to those charged on the larger trades and on sales of mutual fund shares.

We believe that the market makers in such a system will want to deal at net prices. The Commission Rate Hearing showed that member firm block positioners view the minimum commission as only a component in arriving at what is the actual net bid or net offer. A mandatory commission is an obstruction to a market maker and where present, permits the type of distortion exemplified by the give up. In addition, it creates a misleading price to the public to the extent that the transaction is publicized on the tape.

We consider it essential in such a system that all broker-dealers, including exchange members, have access to all market makers directly, without restriction, when handling orders over a certain minimum size or when in their judgment their customer is better served by going off board. Exchange members could act either as a market maker in the negotiated market or as a broker in the auction market. Non-member market makers could deal directly without commission with member market makers or member brokers on transactions over the established minimum size but would, of course, have no access to the auction market as a broker. However, some form of net trading between exchange specialists and non-member market makers should be encouraged. In the final analysis, the essential new ingredient of a combined system—the sine qua non of the true Central Market Place—is increased competition through greater access to all market makers by all participants.

PART II

The New York Stock Exchange in trying to preserve its concept of the Central Market Place has made a concerted effort through public utterances and letters to regulatory agencies to discredit the Third Market by charging that it is unregulated, as compared to the New York Stock Exchange, lacks adequate standards for reporting to the public, and assumes no responsibility in market making.

While we view these efforts as nothing more than an attempt by the New York Stock Exchange to preserve an illegal, monopolistic method of controlling trading in listed securities, we do recognize the impact that constant reiteration can have. Therefore, we would like to discuss these matters at some length with the Commission.

Reporting

One of the arguments that the New York Stock Exchange is using to protest the growth of the Third Market and inhibit the evolution of a combined system of auction and negotiated markets for listed stock is the absence of a stock ticker to report trades in the Third Market. The Exchange's argument is that the public interest is protected by the reporting of each sale and that any departure from this reporting is somehow malevolently clandestine.

We have always viewed the New York Stock Exchange ticker as primarily a sales device to induce trading, with any protective regulatory purpose as secondary. If its principal purpose were regulatory or in the public interest, then one would think the New York Stock Exchange would insist that all trades entered into by its members be printed on the tape for the benefit of the public, including transactions crossed by member firms on the regional exchanges, special purchases and sales by specialists made away from the Floor, off board transactions in exempt securities, and the few Rule 394(b) trades that take place. The New York Stock Exchange's lack of consistency in its application of principle puts in question the principle itself.

As a major Third Market maker, we are not adverse to the daily reporting of our trades in some manner to the public if the public is interested or if the Commission feels such reporting serves a regulatory purpose. Such publicity could be accomplished by publishing markets and volumes in the daily papers, much as O-T-C stocks are handled. If the Commission were to conclude that the ticker tape has a true basis as a public information

vehicle and not as a merchandising tool, we would be happy to join the entire industry in reporting trades on a tape that was available to all market places. However, we point out that institutions are finding that the last sale on the New York Stock Exchange ticker is less and less a guide to the price at which they can buy or sell large blocks. Too often, there is a large disparity between the last sale of 100 or 200 shares and the price at which a large block is eventually liquidated. More important to the institutional buyer than the last sale is the present bid and ask price of the market maker and the size of his market. This fact should be taken into account in considering any industry-wide system. Perhaps, the auction market should continue to report actual last sales while the negotiated market reports bids, asks and size with a summary of volume and range at the end of the trading day. Such reporting would exceed the present reporting in the corporate bond market where only the auction market trades are reported on the New York Stock Exchange ticker tape.

Regulation

Absence of regulation in the Third Market has been cited by the President of the New York Stock Exchange and others in the Exchange community to discredit the Third Market and to support the Exchange's own restrictive policies. We discuss these charges here at some length because regulation of the auction market and regulation of the negotiated market and the interrelationships of such regulation should be thoroughly understood.

To begin, our firm is not adverse to any regulation of the Third Market by the Commission or by the N.A.S.D. if it appears that such regulation is necessary to curb questionable practices or to protect the integrity of the market. However, we are not anxious to be burdened with the expense and inconvenience of reporting under regulations that are unnecessary to the public interest.

Mr. Haack testified in the Commission Rate Hearing that, "third market makers are subject only to the fraud and anti-manipulative rules of the S.E.C. which relate to all brokers and dealers." He then went on to cite the ways in which a specialist is "regulated," some of which are totally unrelated to Third Market operations and some of which he errs in assuming that there is no Third Market equivalent. For instance, he ignores the capital requirements and the obligation to make a continuous market imposed on a Third Market dealer who registers as such with the Commission under

Rule X-17A-9. He states that the specialist cannot “walk away” from a market without Exchange sanction, thereby implying that Third Market makers can and often do. In this respect, we cite the specialist’s monopolistic position as reason for his regulation in this area. We may have the ability to “walk away” from a market-making responsibility, but our competitive desire to keep our customers precludes our exercising this option very often. Our increased activity during times of market turmoil also suggests that “walking away” is not our regular practice.

Mr. Haack makes the point repeatedly that Third Market makers are not required to be a stabilizing influence on the market. We agree—we are not so regulated. Nor is the specialist in any effective way. By the nature of our business in a negotiated market place, we are almost certain to get more sellers in a falling market, and thus buy more; and more buyers in a rising market, and thus sell more. Our firm’s conduct during the weeks surrounding the market break of May 1962 was specifically reviewed by the Commission. We are proud of that record for it shows inventory changes generally counter to market movement and increased, not decreased, activity. The small amount of business we do with other market makers and our policy of never selling stock through a broker on the New York Stock Exchange virtually eliminates the likelihood of our market-making being an unstabilizing force. Here again we say if investigation by the Commission reveals a defect, we are ready to talk of remedies.

Mr. Haack points out that Exchange regulations prohibit short sales below the market and that no comparable prohibition exists in the Third Market. He is right in theory, but wrong in fact. To the extent that an institutional client wishes to buy stock, we may short to him in the process of filling his inquiry. In such a case, there would be no reason for us to sell at a price lower than the last published market price, as our price to him is net of commissions. To our knowledge, we have never sold stock short to anyone below the last published sale.

Third Market firms, of course, could not legally go short on down ticks through sales on the New York Stock Exchange even if policy permitted them to sell on the Exchange, which ours does not. However, there does exist the possibility that a client might sell short to a Third Market firm stock which the client can borrow elsewhere for the purpose of making delivery. Such a sale would not affect the price on the New York Stock Exchange unless the stock were resold on the Exchange. Were it resold on the Exchange, there is a theoretical possibility that such stock could be sold on a

down tick. We point out, however, that this possibility exists through any intermediary, including a New York Stock Exchange member, who accepts short stock from a customer who has his own sources for borrowing that stock to make delivery.

The primary cause for most of the regulation of the specialist is the fact that the dealer function in the Exchange market has become an exception to the American way of free enterprise and open competition. On the Exchange, the market-maker function has narrowed to the point where a monopolistic grant is given to a single specialist in each security. This specialist enjoys an exclusive franchise to make a market in his stock while, at the same time, he is exposed to the flow of public inquiry in that stock and charged with keeping the order book. In our opinion, most current regulation of the specialist and of the Exchange Floor has evolved through obvious need illumined by past abuse. Just as monopolies in public utilities have been subjected to regulation not bestowed upon other businesses, so the specialist must accept special regulation along with his privileged position.

The Third Market on the other hand is part of the huge O-T-C negotiated market place for bonds and stocks where regulation of the market maker has traditionally and successfully been achieved through open competition between independent dealers vying for the business of brokers, banks and other knowledgeable institutions entering the market with orders to place.

In the evolution of the Central Market Place for listed stocks, combining both auction and negotiated markets catering to institutions, we see no reason for the Commission to impose identical regulations on each segment. Such identity would be meaningless and illogical given the differing structures of those markets and the varying degrees of competition. It is no coincidence that institutionally dominated negotiated markets are the most competitive and the least regulated of all in the securities industry.

Responsibility

The New York Stock Exchange has questioned the wisdom of permitting the Third Market to operate without a formal charge of responsibility for maintaining fair and orderly markets and for maintaining minimum standards of business conduct.

Here again, should N.A.S.D. regulations be held insufficient, we have no objection to formally committing ourselves to the responsibility for maintaining fair and orderly markets similar to that which exists in the New

York Stock Exchange regulations. Nor would we object to any surveillance or reporting that the Commission deemed necessary to determine whether minimum standards of responsibility are being met.

On the other hand, we are convinced that free and open competition is the best regulatory force available and that such competition imposes a level of responsibility far higher than minimum standards formally stated.

Furthermore, we find it very hard to take the New York Stock Exchange seriously in this regard. Mr. Haack stated recently that, "competition in market places should be decided on the basis of depth and liquidity and overall performance and not on gimmickry or disparate regulation." We agree completely. We are willing and, we believe, able to compete on these terms. However, it is the New York Stock Exchange which has imposed Rules 394 and 394(b) upon its members, thus acting to protect its Floor from effective competitive bids and offers from the Third Market, thus placing its member brokers in the position of not being able to exercise their primary fiduciary responsibility of securing the best execution for their customer. We have for years been urging the Commission to encourage an obviously unwilling New York Stock Exchange to change these two rules. We suggest that the New York Stock Exchange review its defense of Rules 394 and 394(b) and read the Staff Recommendations on those rules prior to further questioning of "responsibility" and "minimum standards" in the Third Market.

PART III

The combined system for trading listed stocks which we envision should be more efficient and less expensive than the present system since it would reduce the number of high-cost hands through which an institutional block order must travel. A lot of the fat in the present system would be eliminated, and along with it, the unnatural compensation that accrues to many individuals and firms. Marginal producers and well-established firms, including ours, might find the going so rough that merger or liquidation becomes their only course. It is understandable that this spectre causes some firms to seek a return to the past. It is less understandable or defensible that the New York Stock Exchange lends them support through its policies and actions. The system the Exchange seeks to perpetuate is moribund. The forces acting on the market place for listed stocks are irreversible and will ultimately prevail.

We urge the Commission to resist the temptation to compromise in favor of the status quo. Compromise will only perpetuate present barriers and increase fragmentation of a growing market. Worse still, it will magnify the many distortions that presently plague the industry, distortions that grow harder to eliminate the longer they remain. Why prolong the process of adjustment? How much more responsible in the long run for the Commission to set free the forces of competition and permit a reasonably quick adjustment to the reality of institutional dominance in the listed stock market—a needed adjustment that would not increase the burden of regulatory surveillance of the true Central Market Place.

Yours truly,

s/ DONALD E. WEEDEN
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