THE CENTRAL MARKET

vs.

THE SINGLE MARKET

A Speech By

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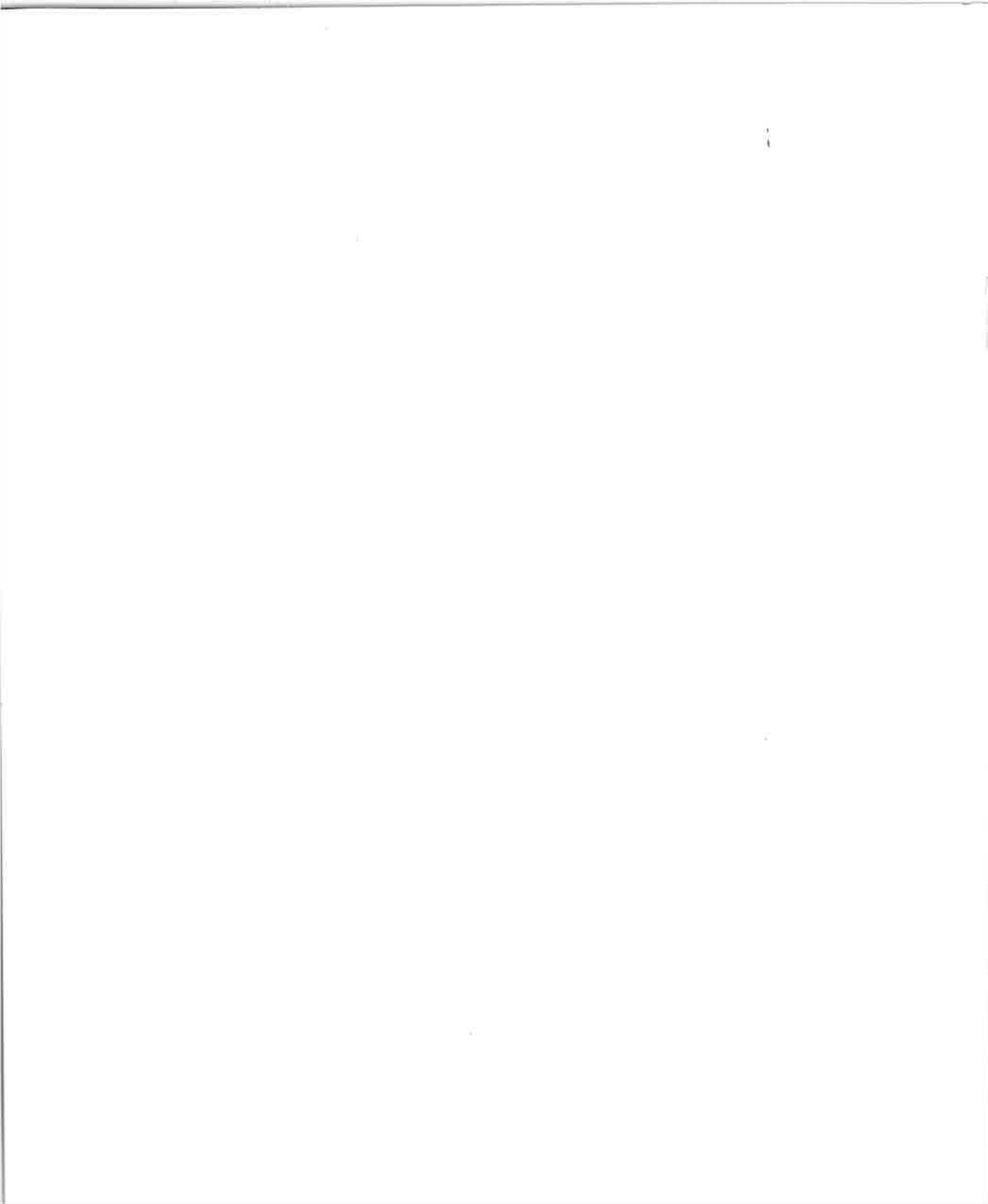

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A major area of concern within the securities industry today centers on the apparent inadequacy of the marketplace for listed securities.

The depth of concern was illustrated when Andrew Melton, President of the Investment Bankers Association, suggested recently that an industry wide committee should be immediately established to work out some acceptable method of improving and consolidating the marketplace for listed stocks.

The institutional investor study has also focused on the problem and will be making recommendations later in the year.

There is no question that everyone believes something must be done although precisely what, is far less clear.

My subject today is titled, "The Central Market vs. the Single Market". It is an attempt by a Third Market maker to deal objectively but realistically with the true nature of this problem and to offer some practical guidelines toward solving it.

To begin with, the hard fact is that there presently exists a multiple marketplace for listed stocks. While these markets are imperfectly connected they do not exist in isolation to one another. Any discussion of the problem must include all the markets. It is only through a full understanding of what the NYSE, the Regionals and the Third Market should provide for the investing public as well as what they can provide, that we are going to be able to fairly assess how well our markets are performing today and what if anything is needed to improve them.

Let me first briefly describe the Third Market. It is the over-the-counter marketplace dealing in exchange listed stocks, predominantly those issues listed on the NYSE. It consists of some dozen or so well capitalized firms who maintain markets in anywhere from a few to over 200 listed issues. By maintaining markets it is meant that a firm stands ready to buy and/or sell for its own account in sizes ranging from an odd lot to large blocks. In the process, it is putting its capital at risk in taking on inventory — both long and short — until such time in the future when another inquiry from another customer allows it to even out its position. The role of the Third Market maker is thus similar to that of the specialist on the floor of an exchange or that of the dealer in government, corporate and municipal bonds. These market makers also may act as agents bringing together a buyer and seller at the same time and charging a nominal commission for this service. But normally their profit is derived from the difference between the price at which they buy shares and the price at which they eventually sell them. Our firm's experience over the years shows an average gross profit per share-turned-over of around 20¢. This cost divided between the buyer and seller who use the Third Market approximates 25% of the minimum cost of processing similar priced stocks in similar amounts through the exchange structure. This fact represents one compelling reason for the growth of the Third Market over the years.

In general, the customers of the Third Market are institutions, such as bank trust accounts, mutual funds, corporate pension funds, and corporations who buy for treasury stock or employee stock purchase plans. They find it advantageous not only in terms of cost but in terms of size, convenience, and efficiency.

In addition, there are the thousands of broker/dealers who are not members of any exchange but who desire to merchandize quality issues to their accounts and who receive orders from these customers in exchange listed stocks. The Third Market allows them to charge a full or at least a partial commission and still remain competitive with the member firm down the street.

Recently, there has been a growing use of the Third Market by member firms who find that in many cases the off-board market maker can not only compete with the specialist in price but is willing to deal in larger amounts. This type of trade is normally executed through the facilities of a regional exchange.

In this connection it is interesting to note an SEC study comparing Third Market prices with those obtained on the NYSE. It reports that prices were more favorable on the Third Market in 87% of the transactions studied when commissions were included. And even when commissions were not included we equaled or bettered the exchange on 43% of the trades. That is real competition and no system which can produce those kinds of savings can or should be held back.

The volume of shares traded in the Third Market has risen dramatically in the past four years. Even though fewer than 400 listed issues are actively traded off-board, the share volume has risen from 58,000,000 shares in 1966 to 155,000,000 shares in 1969 and so far in 1970 volume is running at the rate of close to 200,000,000 shares annually.

The figures on 50 stocks compiled each quarter by the SEC show that in the second quarter of 1970, the latest quarter reported, the Third Market volume equaled 15% of the volume on the NYSE, in those same stocks. The percentage on certain individual issues was significantly higher, for example:

American Can	40%
Caterpillar Tractor	24%
Houston Lighting & Power	51%
Pacific Gas & Electric	64%
Standard of Indiana	45%
Travelers Corp.	32%
Western Bancorporation	78%

These are impressive figures. When viewed in light of a better than 20% per annum growth rate in the 1st half of 1970 over 1969 and compared with a decline in NYSE volume for the same two periods, one must recognize the Third Market as being a significant and permanent part of our total market structure.

The economic purpose of a Third Market is apparent: a market which services institutions in size without charging commissions; a market which provides an opportunity to thousands of non-member broker/dealers to merchandize high quality listed stocks on a comparative basis.

Nevertheless, one might question whether or not the public purpose is being served if its existence supposedly causes "a fracturing of the central marketplace".

Weeden & Co. has discussed this very question in a lengthy letter to the SEC written just a year ago. In our view multiple markets are not fractured unless they are isolated from one another. That is to say the Central Market is a communication concept, not a piece of real estate on Broad Street. With today's EDP possibilities we can and should have a central market stretching from London to Tokyo made up of competing market makers with access to all inquiries by all buyer and sellers. In the process the NYSE will either become more efficient or lose its dominant position.

Over the years several forces have combined to encourage a true Central Market composed of competing market makers, rather than a Single Market.

First of all, there is the overwhelming increase in institutional business. The hard truth is that the institutional investors are better served by a negotiated market than by an auction market. The institutional investor prefers to control his own orders; 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 result has been that institutions have used the Third Market to an increasing degree and have turned to the regional stock exchanges where the rules permit a distribution of excess commissions for the benefit of the institution. In the case of the Pacific Coast Stock Exchange and the Philadelphia, Baltimore, Washington Stock Exchange, the institution is even allowed membership and the opportunity to save the entire commission.

These are practical and compelling reasons for institutional business to be directed away from the NYSE. This business can only be recaptured by a change in commission rates or a change in NYSE rules which would allow institutions to become members.

I am not in favor of institutions becoming members of the NYSE for the reason that it would tend to magnify their already extensive conflicts of interest as well as their economic power. Nevertheless, I can see no justification for excluding them on the argument that their membership will either destroy the auction market for the little investor or that the loss of commissions from institutions will break the back of an already impoverished industry.

One must keep in mind the facts. Before 1960 institutional business was minimal for the vast majority of brokerage houses; to say that in the past nine years the brokerage community has become dependent upon institutional business only tends to amplify the fact that commissions charged on this kind of business have been excessive. Also from 1960 to 1969 the growth of individual public volume on the NYSE has more than doubled, in spite of the growth of the institutions. The individual round lot market is today more active than it has ever been and there is no reason to believe that it will not continue to grow especially if the NYSE's conception of the central auction market is changed to a more rational one. There is no reason to conclude that this trend should alter as a result of institutions becoming members.

Another force that has encouraged a central market made up of multiple market makers rather than a single market dominated by a single exchange, has been the growing resentment from those in our business who are effectively denied access to that exchange; namely, the many thousands of non-member broker/dealers and others who act as intermediaries. They are prevented from joining either because of insufficient capital (to buy a seat) or because of restrictive rules prohibiting their membership. These firms have directed their business elsewhere in search of the opportunity to earn a reasonable commission on their customers orders. It used to be that they had no other place to go, but now with the availability of other competing markets these broker/dealers, foreign banks, and other intermediaries have either joined regional exchanges or taken their business to the Third Market.

Another force for change comes from the well capitalized dealer firms who serve as market makers in many types of securities and who wish to actively compete for the available dealer business in listed stocks. In part, this arose out of an interest to add another facet to their profit making capability, and in part it came from the request of institutions who were exhibiting a growing dissatisfaction with the depth of the exchange market.

A fourth force, has been the development of sophisticated communication facilities and computer technology over the last decade that are highly suitable for improving the efficiency and speed, and reducing the cost involved in trading and processing of securities.

All sorts of new systems are being devised to make use of available technology. For example, there is Instinet which provides a system for direct negotiation of transactions between institutions. Then we have Autex which is an information system to bring buyers and sellers together. There is the NYSE's own BAS or Block Automation System which, as Autex, does not provide for trading through the system but only the information to bring buyers and sellers together.

Finally, there is the NASD's very exciting Automated Quotation System known as NASDAQ. This system will not only have the effect of improving the efficiency of the marketplace but also will have the effect of "centralizing" the over-the-counter market in both listed and unlisted stocks. It is this type of system that can give visibility and substance to the fact that multiple markets can and do act as a central marketplace.

These forces of change and progress are clearly bringing the competing markets together. They are requiring that our industry grow to meet the new requirements being demanded by the rapidly increasing individual and institutional trading in listed stocks. Specifically they are telling the NYSE to both broaden and modernize its structure or lose its dominant position. And finally they are showing the industry how to use modern technology to lower its present costs of service and still allow for a fair return on capital.

If a Central Market is our goal I believe the following must be the objectives of those concerned with the market structure of the future:

1. It should provide for competing market makers whose responsibilities are clearly defined.

2. It should allow for an auction between public orders to take place whenever possible.

3. It should allow for an interface between the auction market and all market makers who will be primarily servicing the institutional market.

4. It should include or allow access to all groups with a legitimate purpose for being included.

5. It should provide for automated and centralized reporting of price and volume information on all trades done in both the auction and negotiated markets.

In achieving these objectives, there are three paths open:

1. Rely on the NYSE to sense the need for change and the necessity of lowering its barriers. History does not support this possibility.

2. Have the SEC or some "think tank" group preordain and implement a new structure by fiat. This I believe, could well result in a much inferior structure which could end up losing the support of the industry's capital and talent.

3. Let competition with its tremendous imagination and vitality determine the new structure, with the regulatory agencies acting only to remove the artificial barriers which presently prevent this competition from operating freely.

I believe under our American system of free enterprise, that this last approach is the most suitable and proper way—and really the only way—to bring the securities markets forward into the Twentieth Century.