"Competition: Key to Market Structure"

Remarks By

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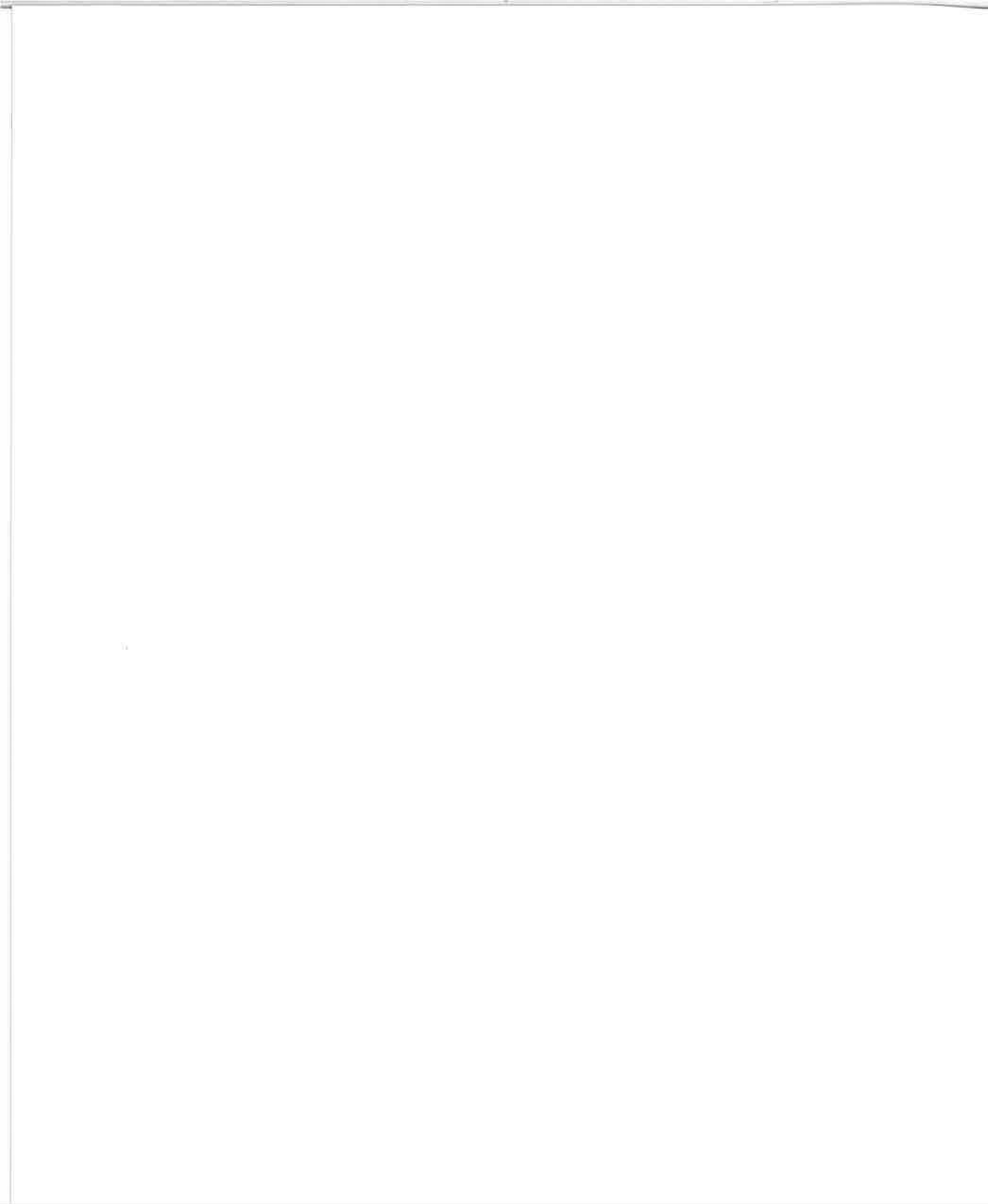

"Competition: Key to Market Structure"

Weeden & Co.'s business is that of making markets. We do it in many different types of securities and we take considerable inventory risk in the process. As market makers we learn to be direct in our dealings. "My market is 62 bid; offered at 62½." "I can offer 5,000 at 62½ net." The pace and the pressures of the market place tend to make us impatient of those who speak in vague terms, who mask their intentions or who do not know the facts.

On Wall Street, by now, I'm known as an outspoken man. Maybe this is the reason why I have been invited to speak at your 1971 Annual Meeting about "Future Market Structure". The timing of your meeting makes it appropriate, probably even necessary, for me to comment on Mr. Martin's Report to the NYSE which deals principally with future market structure.

I shall preface my remarks with the observation that one has some difficulty in being objective about a report that calls for his elimination. While I have tried to keep my thinking reasonably clear and my tone measured and constructive, I think you should be aware of this bias.

Competition or Concentration?

Let me start by quoting Milton Cohen, past Director of the SEC's Special Study of Securities Markets, and presently General Counsel of the Midwest Stock Exchange. In a recent letter to the *New York Times,* Mr. Cohen writes that "the critical question [for our industry] is whether greater concentration or enhanced competition is more likely to produce the result consistent with the public interest." Mr. Cohen concludes that competition is the path to take.

On the other hand, the Martin Report has opted for increased concentration. It recommends the formation of a securities exchange with complete monopoly powers and calls for legislated immunity from the antitrust laws. Whether consciously or unconsciously, Mr. Martin has bought the party-line of the men who employed him and who served as his principal advisors. I do not believe that an enlarged NYSE with competition excluded is in the public interest.

Put another way, competition to the Exchange Floor is what the Pill is to Sex. It's new, and it's good, but it's got the old folks all upset. By opposing competition, by trying to turn the clock back to the good old days, the Martin Report has about as much relevance as a 1930's marriage manual.

Unfortunately, considering "the many important decisions postponed pending the report's completion . . . the magnitude of the opportunity lost is staggering." These words are not mine. That is Donald E. Farrar, Director

of the SEC's Institutional Investor Study, writing in the current issue of the *Financial Analysts Journal*. For him, the Martin Report is a "Great Leap Backward."

The advantages of competition are too compelling to be denied. As the *Wall Street Journal's* August 6, 1971 editorial put it:

> "It is hard to believe . . . that the securities industry is so different from other businesses. . . . If there's one improvement the industry needs more than any other it is increased efficiency, and competition offers the best if not the smoothest way to achieve it."

In the same vein the August 14, 1971 editorial in *Business Week* called the Martin Report, "The wrong prescription for Wall Street's ills," saying:

> "What Wall Street really needs is not a tighter monopoly of securities trading but stiffer competition to purge it of inefficiencies. By ignoring this, the Martin Report has lost Wall Street a chance to bring about reform on its own."

NYSE: A Public Auction Market?

In my opinion the Martin Report fails because it ignores the realities of today's market place. First of all, the Report is based upon the false premise that the New York Stock Exchange still functions primarily as a public auction market. Back in the 1930's the average trade was little more than 100 shares. The institutions only bought bonds. The pace was slower. A broker had time to seek the counterpart to his public order in the crowd.

The specialist only occasionally had to participate in a trade. A public seller met a public buyer most of the time.

Today, when one adds up dealer transactions by specialists, crossed trades negotiated upstairs and taken to the Floor only for record purposes, and stocks positioned by members acting as dealers as well as other member trading, you have accounted for close to 60% of the action on the Floor.

Add to that negotiated block trades on the NYSE of less than 10,000 shares, and trades on the regionals and in the Third Market, which are almost entirely negotiated crosses or dealer trades, and you find that auction trades between public customers account only for a small part of the total business being done in listed stocks.

The fact is the market in listed stocks today is a negotiated/dealer market with some auction aspects and no amount of wishful thinking or monopoly legislation is going to change it.

Adequacy of The Specialist System

The Martin Report blames competing markets for fragmenting the market place. The fact is that the antiquated specialist system with a single monopolistic market maker in each security proved completely inadequate to handle the supply and demand imbalances brought about by large institutional orders. It was inevitable that competing market makers would develop to fill this void—and it is fortunate that we did.

In calling for the elimination of these competing markets, the Martin Report ignores the facts contained in the Institutional Investor Study. This Study, completed only last year, found that all market makers, whether NYSE specialists, regional specialists, or over-the-counter Third Market dealers, tend to stabilize in the sense that they typically buy on balance when prices decline, and sell on balance when prices rise.

Thus, the Martin Report fails to realize that to shift present inquiry from other markets to the NYSE is to place additional pressure on an already inadequate dealer structure. It does not provide for increased liquidity and depth as the Martin Report would have one believe.

And, it does not advance one's understanding of market structure to ignore these facts.

Why Investors Use The Third Market

The Report makes other assumptions which in my opinion are wrong. It implies that when the Wells Fargo Bank or some other institution comes in to Weeden their purpose is to conceal their transactions or avoid regulation. Our experience says this is nonsense! The Wells Fargo Bank operates in a fish bowl of disclosure and regulation and the Third Market welcomes all the publicity it can get. Unlike the New York Stock Exchange which gets free publicity every day from every major newspaper in the country in the form of daily price ranges and volume figures, we have to pay for every ad telling the public what stocks we trade, in what volume and at what prices.

For years we have urged privately and publicly that our trades, along with those of all the exchanges be printed on one tape during the course of

the day and totalled for volume and price range at the end of the day. The Martin Report also makes this proposal. But regrettably in the past the New York Stock Exchange has refused to go along. Their problems are two-fold: first, they hate to admit that we even exist or that we are anything other than thieves in the night even though we now do 20% of the block business, and in some institutional issues are the primary market. Second, they don't want to lose the tape as their exclusive marketing tool. I can appreciate their reluctance. Nonetheless, a public tape recording all trades executed through all registered Stock Exchanges and all registered Market Makers would be a giant step toward centralizing the total market place. This could be accomplished with minimal technical delay and without legislation.

The Institutional Investor Study made it perfectly clear that institutions come to the Third Market because we offer markets in depth. Other SEC studies have confirmed this.

The Martin Report completely ignores this fact. At the same time it recognizes the present inadequacies of the specialist system: namely, that while the specialists are required to provide the same service, experience shows that they are increasingly unable or unwilling to do so. The Report recommends increased capital requirements and tighter regulation while ignoring the fact that similar recommendations in the past have not done the job. Nevertheless, the Report supports foursquare the specialists' monopoly franchise while common sense and the Institutional Investor Study tell us that if specialists can make monopoly profits without fear of competition, many of them won't take the risks.

By contrast, the block positioners who came along in the sixties are under competitive pressure to get into the pit and on the very large blocks they do a fantastic job. On the 500 to 10,000 share lots, however, we are usually faster and cheaper and consistently competitive.

Fixed Commission Rates

Those points in the Martin Report which I have already discussed and which I consider inaccurate lead me to question other recommendations in the Report.

Take, for example, the Report's support of a fixed commission structure. The justification offered is the fear of unhealthy economic concentration. I see no supporting facts—just speculation and a warning.

You know, brokerage firms have failed, do fail, and will continue to fail when they lose efficiency. Look at the record. There were as many big firms as small firms that went under or had to merge in the last two years. You simply can't explain away those who survived by saying they were big. There is a heck of a lot more to Merrill Lynch than size alone. It is a tightly-run ship where the customer comes first and sloppiness and conflicts of interest are not tolerated. All of us in the securities industry know that on the retail side the smallest firm can be the stiffest competition.

In effect, the Martin Report is saying that if you fix rates unnaturally high you will continue to attract and keep in the business those who should never be there in the first place. Bear in mind that Weeden & Co. has the most to gain by the New York Stock Exchange keeping its rates high and fixed. The higher and more rigid those commissions, the larger the spread we have in which to make markets. High, fixed commissions in the new National Exchange System would be in my economic self-interest. But I can't with a straight face accept the Martin Report proposition that high, fixed commissions are in the public interest and are necessary to avoid unhealthy economic concentration.

Competition and Regulation

Finally—and most seriously—the Martin Report commits the 1930's fallacy of opting for regulation rather than competition. Really, the Martin Report is nothing more than N.R.A. in a new wrapper. This industry may have its problems. But surely, they are not so bad as to revive the Blue Eagle.

There must be something about government which distrusts competition. For Republicans and Democrats alike, the bureaucratic response for reform is always more regulation rather than more competition.

Let me give you one small, but striking, illustration. In 1970 the New York and American Stock Exchanges ganged up on the NASD and got them to exclude Third Market securities from NASDAQ. The SEC went along. We had to plead with the NASD and speak to the Justice Department to let us put 30-odd listed stocks on NASDAQ on an initial 90-day trial basis. Five months later we are still on a trial basis, even though we have narrowed the average spread on those stocks by the New York Stock Exchange specialists by 12%—some as much as 25%. The specialists have acknowledged that our competition publicly displayed on NASDAQ in those 30 stocks keeps them on their toes. The wonders of competition! In

1971 anything—anything—which keeps the specialists on their toes is in the public interest. And yet we had to fight the regulators to get on that system with 30 stocks on a trial basis in order to show what we could do. Imagine what we can do when we have 250 listed stocks on NASDAQ.

My prejudice against regulation as a substitute for competition runs deep. Chalk it up to my western background—or being the youngest of four boys.

It appears to me every time you undertake to regulate a field of business, you subtly change that industry. Inevitably, those in the field see the advantage of hiring experts to keep them in touch with the regulatory agency. Someone good at "interfacing" with government. Well, if these experts do a good job, pretty soon the regulators share industry's point of view—meaning the point of view of those big enough to afford effective, full-time lobbyists. Before you know it, there is a little job swapping—the regulator goes into private industry because he "knows the ropes"; and industry returns the compliment by controlling the nominations of the new regulators. After awhile, the regulated and the regulators are locked in deadly embrace—and then you have the Lockheed Loan Syndrome, complete with White House breakfasts.

And that is all the Martin Report is—another version of the Lockheed Loan: a proposed subsidy for the New York Stock Exchange by means of a legislated enlarging of its monopoly power because it cannot itself make the changes required to keep it efficient in a competitive world.

Future Market Structure

The alternative is simple—in fact, in some ways is practically here. What are the essentials?

1. Competing market makers
2. A common tape
3. Negotiated rates
4. Open access

First of all, open up the market making function to everyone who wants to participate. Require from them adequate capital and make them conform to whatever rules and regulations are in the public interest—the public's not the NYSE's interest.

Use the computer to the maximum to hook up these competing markets. Make them accessible to all inquiry, large and small. There is no question this can be done.

Experiment with automated trading. Test the full capacity of NASDAQ. There is nothing sacred, let alone necessary, about a bunch of guys running around the Floor at Broad and Wall dusting each other with talcum powder.

As I have said many times before, an exchange is a communication system, not a piece of real estate.

One must eliminate the present barriers between markets that cause inefficiency and high costs. One must interface the small public inquiry and the big institutional trade. A good start in this direction has been made on the Cincinnati, Detroit and Philadelphia Stock Exchanges where Third Market firms have been invited to act as specialists and alternate specialists right down on the exchange floor—another example of the fact that innovation comes out of competition.

Create a public tape. Take the present stock tickers and spin them off into a separate Comsat-type company. Print all transactions in all stocks on one central tape. Once we have a common ticker and the newspapers are reporting consolidated volume and price ranges, many of the other pieces to the problem will naturally fall into place.

Negotiated rates. The New York Stock Exchange is not a public utility and every time they pretend they are, they are forced to prostitute themselves before the SEC with contrived statistics to justify what you and I know are not utility-type returns on invested capital. While one has the impression that our industry is fully regulated, in fact it still falls far short of regulation over profits. You only have to read the prospectuses of Donaldson Lufkin, or Merrill Lynch, or read about the 100% return on invested capital by specialists, to understand this. In my opinion, present efforts by the NYSE to maintain a fixed commission structure are moving the industry closer and closer to governmental regulation of profits. Immunity from antitrust must necessarily accelerate this.

Moreover, the hard facts are that excessive fixed commissions are the cause of bad reciprocal practices which are still with us—and complicate and aggravate the issues of institutional access and competing dealers. But for excessively high fixed commissions the Martin Report would not have been necessary at all, since the members of the New York Stock Exchange would have otherwise been forced to fashion the reforms necessary for their collective survival.

Finally, an essential ingredient of a central market is open access. Qualified members of our industry should not have to pay an entrance fee to a

private membership club in order to have access to the market pl
a requirement, as recommended by the Martin Report, is inconsis
the public character of the market.

If, despite negotiated rates, an institution still wishes to do bu
rect, without the use of a broker, this is its right. I'm not talki
membership—I'm talking about access. You and I know full well t
of the big banks, insurance companies, and mutual funds have t
knowledgeable and professional as any broker. There is no econ
tification for denying them direct access to the market makers
stocks any more than in government bonds, municipal and corpora
and unlisted stocks—and any effort to do so will only enhance t
and Fourth Markets. On the other hand, if one accepts the con
institutional exclusion is in the public interest with respect to liste
why should it not apply to government bonds, municipal and
bonds, and unlisted stocks?

The suggestion by Mr. Martin that Bernard Cornfeld's I.O.S
direct access, could distort a market is a red herring. Without dire
I.O.S. was never at a loss to find brokers willing and anxious
bidding. The solution to the problem of possible manipulation li
closure and control, not exclusion.

These four essentials—competing market makers, a common ta
tiated rates and open access—are practical, feasible reforms whi
more than build on the present realities. No new legislation is nee
common thread that runs through all four suggestions is to enha
petition, not to suppress it. Only competition—that fantastic am
everybody doing his own thing—will bring about acceptable, fl
forms which do not favor those with political clout trying to
privilege over those who are simply doing a workmanlike job,
business by servicing customers.

There are no messiahs and we should stop waiting for them.
open competition properly supervised has served the public effe
the past and should be relied on to carry the main burden of d
the market place of the future.

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