SEC AUTHORITY OVER THIRD MARKET TRADING

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

ON

S. 3126

TO AMEND THE SECURITIES AND EXCHANGE ACT OF 1934 TO AUTHORIZE THE SECURITIES AND EXCHANGE COMMISSION TO PROHIBIT BROKERS OR DEALERS FROM TRADING LISTED SECURITIES OTHERWISE THAN ON NATIONAL SECURITIES EXCHANGES IN THE EVENT THE COMMISSION DETERMINES THAT SUCH TRADING IS CONTRARY TO THE PUBLIC INTEREST AND THE PROTECTION OF INVESTORS

MARCH 27 AND 28, 1974

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SEC AUTHORITY OVER THIRD MARKET TRADING

WEDNESDAY, MARCH 27, 1974

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 1:30 p.m. in room 5302 of the Dirksen Senate Office Building, Senator Harrison A. Williams, chairman of the subcommittee, presiding.

Present: Senators Williams, Biden, and Bennett.

Senator WILLIAMS. This hearing will come to order.

We begin hearings today on S. 3126 which would grant the SEC authority under carefully defined circumstances to confine trading in listed securities to registered stock exchanges. In its simplest terms, S. 3126 is intended to insure that the mechanisms of the existing auction markets are preserved and protected until such time as we have an alternative to them, namely a national market system.

We are all aware of how rapidly conditions and behavior are changing in the securities industry. The most significant change of all will come in April 1975 when fixed commission rates are finally eliminated. The big question at that point will be the impact on the fairness and orderliness of the auction markets.

This subcommittee in its Securities Industry Study report, the SEC in various statements, and the Department of the Treasury in its recent capital markets statement, have concluded that the elimination of fixed commission rates will be beneficial. There may be a shake-out period, but most of us believe that the securities industry will emerge stronger and the public better served.

A number of responsible persons, however, do not share our optimistic expectations. The New York Stock Exchange, in particular, argues that the elimination of fixed rates will remove the primary incentive for firms to belong to stock exchanges. With that incentive gone, so the argument runs, firms will leave the exchanges, execute their orders in the third market or in their back offices, and thereby erode the strength of the auction market and the protections it provides public investors.

I do not share the New York Stock Exchange's fears, but I think we can all agree that no one can predict with absolute certainty what will happen once fixed rates are abolished. The New York Stock Exchange may be right, and that is the point of S. 3126. Focusing on the period between the end of price-fixing and the establishment of a national market system, the bill would direct the SEC, if it finds that trading away from stock exchanges—that is in the third market—is causing

serious harm to the fairness or orderliness of the auction markets, to require broker-dealers to confine their trading in listed securities to the exchanges.

There is, of course, a very important caveat to the bill's mandate. The values and protections of the auction markets, as important as they are, do not by themselves outweigh the benefits from competition. Accordingly, S. 3126 states that before the SEC can take any action to restrict third-market trading, it must ascertain that restrictive stock exchange rules have been amended so that firms now operating in the third market would be able to do business on the exchanges with no anticompetitive impact. In other words, under no circumstances would the bill put firms now operating in the third market out of business. Rather, it would require, if the NYSE's fears are realized, that third market firms be integrated into the auction markets in such a manner that they would be at no competitive disadvantage.

During the transition period until the establishment of a national market system, the SEC will be called upon to do a good deal of delicate balancing. Competition must be fostered, but at the same time, existing institutions must continue to function until there are available alternatives. The automation capacities of the securities industry must be improved, but this cannot be done at a cost which would drive a great many firms out of that industry. And trading should be centralized to assure customers best execution, but the health of regional financial centers must also be maintained. I could go on with examples, but I think the kind of regulatory balancing I have in mind is obvious.

Balancing diverse objectives is a difficult job, and I think by and large the SEC has done it well. But, in at least one area, I am afraid matters have gone askew. I have in mind the problem of equal regulation as it relates to dealer activities in the third market, on the one hand, and on the stock exchanges, on the other.

We have been told for a long time that equal regulation should be delayed in the interest of preserving and fostering the competition the third market provides to the specialists on the New York Stock Exchange. I believe in that competition, and I believe that on balance it has been beneficial to the markets and investors. But there comes a point after which we must turn our attention from the fact of competition to its fairness.

Let me give some obvious examples.

In contrast to the exchange markets, there is no public reporting of transactions in the third market, nor are all third market quotations available for public scrutiny. Third market dealers are not subject to antimanipulative rules of anywhere near the stringency of those under which the specialists operate. Third market dealers have no obligation to honor public limit orders and indeed are not even obligated to execute their own customers' orders ahead of orders for their own accounts. Whereas specialists must trade so as to enhance the continuity and depth of markets, third market dealers have no such obligations—indeed they are not even required to trade in a manner consistent with the maintenance of an orderly market. Third market dealers can enter or leave the market at will. And short selling, which is so carefully circumscribed on the primary exchanges, is subject to no restrictions in the third market.

The competition that is provided by the third market is valuable and should be preserved. S. 3126 would do this. However, competitors should play according to similar rules. In my view, the balance between competition and investor protection with respect to the third market is out of whack. The time has come for the third market to be regulated a little more equally. I intend to discuss this point further this afternoon with Chairman Garrett of the SEC when he testifies.

We have a full 2 days of hearings on this important legislation. I hope that we will have a full and profitable exchange of views.

Our first witness today, was scheduled to be the Senator from Michigan, Mr. Hart. However, he has written me that it will be impossible for him to testify either today or tomorrow. Although Senator Hart will not testify, I will quote from his letter to evidence his interest in this matter. "Your letter inviting my comments on S. 3126 is very much appreciated. To facilitate focusing on the substantial antitrust policy questions raised, on Tuesday I introduced an amendment designed to provide competitive standards and safeguards. I trust that next week's hearings on S. 3126 will evoke comment by SEC, the Antitrust Divisions, and others on this approach. Regretfully, I will not be able to appear at the hearing on the 27th or the 28th. I will, however, be happy to file a statement on the competitive implications of S. 3126.

Again, my thanks for your thoughtfulness in inviting me and my best regards."

I am somewhat disappointed that he has created a focus on another approach. I noticed in the New York Times today an editorial which indicates Senator Hart's opposition to the bill before us here.

If my colleagues have no other statements in response?

[No response.]

We will insert copies of S. 3126 and Senator Hart's statement and amendment in the record, then, let us turn to a man who has done a remarkable job as Chairman of the Securities and Exchange Commission.

[The information follows:]

93D CONGRESS
2D SESSION

S. 3126

IN THE SENATE OF THE UNITED STATES

MARCH 7, 1974

Mr. WILLIAMS (for himself, Mr. BROCK, and Mr. CRANSTON) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing and Urban Affairs

A BILL

To amend the Securities and Exchange Act of 1934 to authorize the Securities and Exchange Commission to prohibit brokers or dealers from trading listed securities otherwise than on national securities exchanges in the event the Commission determines that such trading is contrary to the public interest and the protection of investors.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That section 15 of the Securities Exchange Act of 1934
4 (15 U.S.C. 78o) is amended by adding at the end thereof
5 the following new subsection:
6 "(e) (1) The Commission shall by rule prohibit brokers
7 and dealers from effecting transactions in securities registered
8 pursuant to section 12 (b) of this title otherwise than on a

1 national securities exchange, if it finds, after notice and
2 opportunity for hearing, that (A) no rule of any national
3 securities exchange unreasonably impairs the ability of any
4 dealer to solicit or effect transactions in such securities for
5 his own account or unreasonably restricts competition among
6 dealers in such securities or between dealers which are spe-
7 cialists in such securities and dealers which are not specialists
8 in such securities and (B) as a result of transactions in such
9 securities otherwise than on a national securities exchange
10 the fairness or orderliness of the markets for such securities
11 on such exchanges or the ability of such exchanges to carry
12 out their responsibilities under this title, has been or is
13 likely to be affected in a manner contrary to the public
14 interest and the protection of investors. The Commission
15 may conditionally or unconditionally exempt any security or
16 transaction or any class of securities or transactions from any
17 such prohibition if the Commission deems such exemption
18 consistent with the public interest and the protection of
19 investors.

20 "(2) For the purposes of subsection (1) the ability of
21 any dealer to effect transactions in securities for his own
22 account shall not be deemed to be unreasonably impaired by
23 any rule of an exchange fairly and reasonably prescribing
24 the sequence in which orders brought to the exchange must

1 be executed or which has been adopted in accordance with
2 rules promulgated by the Commission under this title.
3 "(3) Any rule promulgated pursuant to subsection (1)
4 shall not become effective until the rules of national securi-
5 ties exchanges fixing rates of commission have been elimi-
6 nated and shall not remain in effect after the Commission
7 has determined that a national market system for securities
8 has been established or April 30, 1978, whichever is earlier:
9 *Provided, however,* That the Commission may extend the ef-
10 fectiveness of such a rule if it finds that such extension is
11 necessary or appropriate in the public interest or for the
12 protection of investors and reports its reasons for so finding
13 to the Congress not less than ninety days before any such
14 extension begins."

STATEMENT OF PHILIP A. HART, U.S. SENATOR FROM THE STATE OF MICHIGAN

Mr. Chairman: Allow me to express my appreciation for your invitation to participate in these hearings on S. 3126. Although I am no expert on the securities industry, the bill has antitrust implications which concern me. I believe it fair to say that S. 3126 presents the question of whether the future structure of our securities markets will be one of competing markets—exchanges and otherwise—tied together via a national securities market system, or whether it will be essentially the New York Stock Exchange.

On March 5, the Committee on Banking, Housing, and Urban Affairs reported S. 2519—the National Securities Market System Act of 1974—which is awaiting floor action. S. 2519 represents the culmination of several years' arduous labor by the Securities Subcommittee and its staff, and ably implements the recommendations and conclusions of the Subcommittee's lengthy hearings and report on the securities industry. S. 2519 would result in the elimination of fixed commission rates and of the anticompetitive practices and rules of the New York Stock Exchange; a national securities market system composed of competing markets—exchanges and otherwise—would be created; and the Securities and Exchange Commission would be required to afford significant weight to competitive values in carrying out its responsibilities under the Securities and Exchange Act of 1934. Reconciliation of conflicts between the antitrust laws and the securities laws is left to the courts under the test enunciated in *Silver* v. *NYSE* and *Thill* v. *NYSE*.

In short, the Subcommittee came down squarely on the side of competition in the securities industry as best serving the public interest. S. 2519 has my full

support. Unfortunately, S. 3126 runs counter to S. 2519 and the thrust of the Subcommittee's report, and would eliminate the competitive benefits likely to result from enactment of S. 2519.

S. 3126 had as its genesis a proposal made by the New York Stock Exchange—and rejected by the Subcommittee—during consideration of S. 2519. That proposal would have required that all trading of listed securities occur only on registered national securities exchanges. A substantially equivalent proposal was against put forth as an amendment to S. 2519 during mark-up by the Committee on Banking, Housing, and Urban Affairs. The Committee took no action on the amendment which is now before the Subcommittee as S. 3126.

Although different in form and somewhat more modest than the original New York Stock Exchange proposal, S. 3126 nonetheless would achieve the same result: the elimination of the third market as a competitor of the New York Stock Exchange under defined circumstances.

The premise underlying the proposal is the same today as when it was rejected by the Subcommittee in reporting S. 2519. Indeed, the argument is not novel at all, but has been used for many years by the NYSE in justification of its price-fixing and cartel-like operation.

NYSE Chairman James J. Needham testified respecting S. 2519 "that the principal incentive to exchange membership has been the fixed commission rate structure," and that "the elimination of fixed commission rates—would probably make [NYSE member firms] abandon their exchange membership." He concluded that "the auction markets as we know them would rapidly disappear," and that this would be detrimental to the public interest.[1]

More recently, Chairman Needham has been more pointed:

"A number of the major firms have said publicly they will have to consider quitting the Exchange when competitive commission rates become effective—unless appropriate offsetting measures are adopted.

"They include:

"Merrill Lynch, Pierce, Fenner & Smith
"Goldman, Sachs & Co.
"Paine, Webber, Jackson & Curtis, Inc.
"Bache & Co., Inc."[2]

Apart from understandable predictions by NYSE officials of dire consequences resulting from a competitive market structure. I am aware of neither evidence nor legislative or governmental agency support for such speculative assertions. If the NYSE is more efficient than the third market because of the auction process—as it claims to be—the advent of fully competitive rates should result in more rather than less business flowing to the NYSE.[3] As the past President of the NYSE, Robert Haack, said: "I think that with fully negotiated rates business will be done on the basis of depth, liquidity, and continuity of the marketplace."[4]

In this particular instance, we are fortunate that much evidence exists to support the conclusion that the NYSE predictions of doom are less than objective. This is not unusual. In regulated industry after regulated industry, the argument has been made that competition is unsuitable for reasons peculiar to that industry. The arguments—invariably accompanied by predictions of doom—were utilized either in opposition to pro-competitive legislative proposals, in favor of legislative proposals limiting competition, or as a defense to an antitrust suit. While I cannot say that each prediction has been wrong, I am still awaiting the forecasted doom to occur.

In its February, 1973 *Securities Industry Study Report*, the Securities Subcommittee made the following observations with respect to the Exchange's argument and proposal:

"Over the past few years, competing markets have developed for NYSE-listed issues, to the point where about 17 percent of the trading in those issues, and about 30 percent of trading in the most active issues, takes place on regional exchanges or in the 'third market.' This development has been viewed by some

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[1] See Statement of New York Stock Exchange Chairman James J. Needham in Hearings on S. 2519 before Senate Subcommittee on Securities. Committee on Banking, Housing, and Urban Affairs, 93rd Cong., 1st Sess. (November 13, 1973), p. 436 *et seq.*

[2] "Before It Is Too Late", a presentation by James J. Needham, Chairman, New York Stock Exchange, before The Business Council, Washington, D.C. (February 14, 1974), p. 23.

[3] See "Public Policy for American Capital Markets," Department of the Treasury (February 7, 1974), p. 9.

[4] "Study of the Securities Industry," Hearings before the House Subcommittee on Commerce and Finance. Committee on Interstate and Foreign Commerce, 92nd Cong., 2nd Sess. (March 15, 1972), p. 3728.

as a process of 'fragmentation' which is harmful to the interests of public investors. At the same time, *recognition must be given to the public benefits that have resulted, including the traditional benefits of competition—lower charges and better performance.*

"The SEC has called for the development of a central market system with open access by all qualified brokers and market makers. *The NYSE, on the other hand, has been urging development of a central exchange system from which all market makers other than stock exchange specialists would be excluded. The Subcommittee supports the SEC approach. It believes that public investors are entitled to the benefits of the present combination of markets, freed of the restrictions which distort the allocation of orders and deprive them of best execution of their transactions.*" (Page 10)

* * * * * * *

"With regard to the selection of the market or markets in which a particular security will be traded, the Subcommittee believes that investors are entitled to more than half a market; they are entitled to the best combination of the features of the exchange and over-the-counter markets that the trading characteristics of the particular stock can support. Corporate management has no legitimate interest in restricting the trading opportunities of investors who have acquired a company's share. Therefore *the Subcommittee does not believe that trading in 'listed' securities should be limited to the existing exchange markets.*" (Page 13)

* * * * * * *

"d. Consequences of Use of Other Markets.

"Many members of the NYSE, quite naturally, disapprove of this development. The Chairman of the NYSE, in a recent speech, said that this 'fragmentation' was 'the major problem facing our industry today' and 'is the root of all current ills.' While the NYSE has not renewed its 1940 attempt to prevent its members from trading NYSE-listed stocks on any other exchange, it has led the fight to bar institutions from membership on regional exchanges, and has not asked for Congressional legislation to put the third market out of existence.

"It is not hard to find the source of this concern. The migration of orders to other markets has meant a substantial loss of income to NYSE members—perhaps on the order of half a billion dollars a year. In considering the development of a "central market system," however, *the goal of the Congress is not to protect the income of the members of the NYSE, but to protect the interests of public investors.* In that connection, it is necessary to analyze the detriments—and the benefits—that have come to public investors as a result of the diversion of transactions from the NYSE to other markets.

"The principal harms which are alleged to have been inflicted on public investors are (1) that transactions in listed stocks can be effected without public disclosure, and without exposure to public orders, and (2) that dealers in other markets can operate free of salutary restrictions imposed on NYSE specialists. The Subcommittee believes that these are important considerations, and its recommendations set forth below in this chapter are designed to deal with them. At the same time, *recognition must be given to the benefits to the public that have flowed from the development of these competing markets. Chief among these are the traditional benefits of the competition—lower charges and better performance. It is clear that the existence of competing markets was a major factor in obtaining NYSE acceptance of the concept of competitive commission rates—indeed, it is quite possible that in the absence of competitive markets, it would have required litigation under the antitrust laws to commence the movement to competitive rates. There is also evidence that where competing market-makers are operating in NYSE-listed stocks, the spread between bid and asked prices has been lessened, with consequent benefits to public buyers and sellers.*

"*For this reason, the Subcommittee approaches the question of a 'central market system' not from the point of view of returning all trading in NYSE-listed stocks to the NYSE and subjecting all participants in that trading to NYSE rules and procedures, but from the point of view of preserving the competing markets that have developed,* breaking down barriers to communication and competition betwen them, and imposing those rules—and only those rules—which are necessary to protect public investors. The objective of a 'central market system' is to provide a better market, with greater liquidity and depth, to meet the present and future needs of the public—those who invest directly and those who invest through the medium of institutions. [Footnotes omitted]." (Pages 93–94.)[5]

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[5] The "principal harms" relating to public disclosure and unequal regulation have been remedied in S. 2519.

In December 1973, the Securities and Exchange Commission rejected proposals to eliminate the third market, as follows:

"The third market in the past has been an important source of competition in the securities markets. If it remains viable in the future, even without a fixed commission rate to undercut, that will serve as evidence that it provides services which, at least occasionally, specialists cannot, or will not, provide. It has been argued that the third market has achieved its success through unequal regulation—principally because it is not obliged to report its trades on a tape and to clean up limit orders. In this regard, it is interesting to observe that no third market firm has objected to the Commission's proposal that these obligations be imposed on all participants in the central market system. In any case, we believe it would be imprudent to eliminate an established market unless a clear and convincing need were shown and less drastic alternatives simply were not available. We believe there will be ample opportunity following the introduction of competitive rates to observe their impact and to devise solutions to whatever new problems might result." [Hearings on S. 2519, pages 191–192.]

In defending an antitrust suit brought by Thill Securities Corporation, the NYSE sought to defend fixed rates by making essentially the same arguments made in support of S. 3126. Extracts from February, 1973 stipulated sworn testimony of industry leaders include the following statements:

Andrew Sage, President of Lehman Brothers, Incorporated—

"Lehman Brothers would not quit the NYSE due to the phasing out of fixed minimum commission rates; nor would it decrease the quality or quantity of its research and advisory services."

James W. Davant, Chairman of the Board of Directors at Paine, Webber, Jackson & Curtis—

"I do not foresee that Paine Webber would either dispose of its NYSE memberships or decrease its research services under a system of competitive rates."

Gustave L. Levy, senior partner, Goldman, Sachs & Co., and formerly Chairman of the Board of Governors of the NYSE—

"In August, 1968, in my capacity as Chairman of the NYSE Board of Governors, I testified in favor of fixed minimum commission rates before the Securities and Exchange Commission in its Investigatory Proceedings No. 4–144. At that time I expressed the view that if NYSE commission rates were to become fully negotiable, my firm would seriously consider leaving the Exchange and many other firms would actually leave in response to the abolition of fixed commissions on the NYSE. I contended at that time that, as these firms left the NYSE and executed their trades off-board, (i) the depth and liquidity of the auction market would be impaired, (ii) the NYSE's specialist system would be crippled, and (iii) the effectiveness of NYSE self regulation would be undermined, all to the detriment of the public interest.

"Upon further reflection since that time, and as a result of our experience with negotiated commissions on large trades, I have changed my views regarding the wisdom and desirability of moving to negotiated commission rates. I came to the view that it would not necessarily follow that the competitive determination of commission rates on transactions of all sizes would have the adverse effects I had alluded to in my 1968 testimony. *I have rejected the view, and do not now believe, that the advent of fully negotiated commission rates would be likely to cause my firm to leave the NYSE. . . .*

"I had become convinced as a result of our experience over the last few years that fixed minimum commission rates which were fair to all parties were an impossibility, and that *the fixed minimum commission rate system was itself responsible for the increasing and undesirable fragmentation of securities markets.*"

Donald T. Regan, Chairman of the Board, Merrill Lynch, Pierce, Fenner & Smith Incorporated—

"Fixed commissions are one of the causes of trades leaving the NYSE and going to the third market. . . . Continuing fixed rates will make it more difficult for member firms to compete with third market makers."

Before the present emphasis on abolishing the third market, Chairman Needham himself testified at House hearings on the elimination of fixed rates:

"I would like to point out to you something else. With the elimination of minimum fixed commissions as the bill proposes, I think the real incentive of going to the third market disappears." [6]

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[6] Hearings on H.R. 5050, House Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, 93rd Cong., 2nd Sess. (July 19, 1973), p. 997.

Finally, on this point, Mr. Chairman, William R. Salomon, Managing Partner of Salomon Brothers, a NYSE member firm recognized as the largest market maker, in responding to my inquiry wrote on March 21, 1974 that Salomon Brothers has "no plans to resign our exchange membership after the advent of fully negotiated rates," and expressed "disbelief that there would be a mass exodus of other exchange members." He concluded:

"We have previously expressed the view that the competition provided to firms such as ours by third market dealers has created both an opportunity for sometimes better executions by our institutional customers and continuing pressures for constructive change in the securities markets. We have also stated that the absence of competitive barriers to dealing, as presently found in the third market, is a necessary characteristic of the central market system. Along with freely competitive dealing, the implementation of a composite tape, composite quotation system and comprehensive auction mechanism, as recommended by the Commission, would eliminate all important current differences between exchange trading and third market trading. In our view, this is the way to integrate the third market into the central market system and would be preferable to outlawing it." See letter attached as Appendix A.

I recognize that S. 3126 is intended by its sponsor as a "fail-safe" mechanism to be used only in the unlikely event that the advent of fully competitive rates creates chaotic market conditions. But the bill does not focus on ways to assure the maintenance of fair and orderly markets; it seeks to impose a narrow, carefully tailored solution—elimination of the third market—to a hypothetical problem, *i.e.*, member firms leaving the NYSE, whether or not such a drastic solution is necessary to resolve a problem most people do not believe exists. Weeden and Co.'s volume in a number of stocks is close to 30 percent of NYSE volume in the same stocks, 30.3 percent of its volume is with Exchange members, and 80 percent of its transactions are in less than 500 share lots. Under the bill's language, a perfectly legitimate argument could be made that third market trading presently is or is likely to result in unfair and disorderly markets on exchanges.

SEC itself has opposed the bill's inflexible approach, and has taken the position that it has the necessary authority within the framework of S. 2519 to deal with any disruption of fair and orderly markets upon commencement of fully competitive rates. Only if the Subcommittee disagrees with SEC's interpretation of S. 2519 does SEC support legislation dealing specifically with this problem, and then only if amended in several important respects.[7]

Enactment of S. 3126 also would be an invitation to request the hearing provided for in the bill. Valuable SEC resources would thus be diverted from the difficult job of overseeing and nudging along the implementation of the national securities market system, which has already been unnecessarily delayed. As long as hope exists that the third market may be eliminated, substantial progress is bound to be further delayed. Once such a hearing commences—and before SEC renders its decision—the pressure to delay implementation of fully competitive rates will be considerable and appealing. Why risk market disruptions while SEC is studying the problem?

The parentage and rationale underlying S. 3126 compel that solid evidence of need be presented before such an unprecedented delegation of authority to abolish an entire class of competitors is delegated to an administrative agency. SEC's track record on competitive matters has been less than exemplary. Hearings on eliminating fixed commission rates commenced in 1968, and with the latest extension, fully competitive rates are not expected to be implemented until mid-1975. SEC staff recommended in 1965 that NYSE Rule 394 be amended because it was anticompetitive and discriminated against the third market. SEC did not release the study until 1971. The subsequent NYSE amendment is equally restrictive, and SEC is still studying the matter. Other examples include SEC rule 19(b)(2), the listing of securities on NASDAQ, and the recent SEC decision on the consolidated tape plan. As the House report on its *Securities Industry Study* concluded:

"The Subcommittee's hearings show concretely that the Exchange's failings were one of the major causes of the operational and financial breakdowns which constituted the 1967–70 crisis in the securities business. Nor is the Commission without responsibility for the 1967–70 debacle: instead of regulating or super-

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[7] March 1, 1974 letter of SEC Chairman Ray Garrett, Jr., to Senator Harrison A. Williams; February 22, 1974 letter of Harvey Pitt, Executive Assistant to SEC Chairman, to Stephen Paradise, counsel to Senator Harrison A. Williams.

vising the self-regulators, the Commission has usually negotiated with them as if they were coordinate bodies." "Securities Industry Study," Report of the House Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, 92nd Cong., 2nd Sess. (1972), pp. viii-ix.

Should the Subcommittee find appropriate evidence supporting the need for a "fail-safe" mechanism, I hope it will consider the amendment to S. 3126 I introduced (marked copy attached), and which is outlined below. It is designed simply to provide competitive safeguards and standards while according SEC fail-safe authority.

The preamble "consistent with the other provisions of this title, and if necessary to preserve fair and orderly markets" would assure that SEC action directed at the third market is consistent with the policies of S. 2519 and the Securities and Exchange Act of 1934, and that such action is taken only if necessary to maintain fair and orderly markets—not merely to protect the NYSE from competition. For the same reason, the words "on such exchanges . . ." on lines 11 and 12 have been deleted as recommended by SEC. Clearly, if fair and orderly markets are maintained by the third market, then there is no reason for action to be taken by SEC.

Changing "shall" to "may" on line 6 also has been proposed by Senator John Tower and by SEC, and would assure SEC sufficient flexibility to deal with the problem short of eliminating the third market if alternative solutions exist. The addition of the "least anticompetitive" alternative language on line 14 is designed to make explicit SEC's implicit obligation to remedy the problem in the least anticompetitive manner. Similarly, the requirement in paragraph 4 that the Attorney General concur that the least anticompetitive approach has been taken assures adequate consideration of important competitive principles. The words "or practice" on line 2 has been added to assure that Exchange practices as well as rules are not anticompetitive. In substance, this accords with a similar SEC recommendation. Finally, paragraph 5 has been added to make clear that the state of the law respecting immunity from the antitrust laws is not being changed.

The language "is likely to be" on line 13 has been deleted as suggested by Senator Tower and replaced with "in substantial probability of being." Without this change, the third market could be eliminated on purely speculative assertions—such as presently being made—without the need for solid evidence. For the same reason, because the bill is concerned with harm occurring upon commencement of fully competitive rates, and to assure that fully competitive rates are not delayed during the pendency of the proceeding authorized by S. 3126, the commencement of such proceeding is conditioned upon the advent of fully competitive rates.

The addition on line 2 of the words "on the record" is designed to assure that interested persons have an adequate opportunity to present evidence on this important issue, and that those persons are accorded the full protection of the Administrative Procedure Act. This also will serve to avoid subsequent controversy over the scope of the required proceeding as recently took place respecting SEC's Rule 19(b)(2) proceeding.

"Priority for orders of public customers" has been substituted on lines 2 and 24 to make clear the concern for priority of public orders only. Under the broader language of the bill, specialist orders could receive priority over dealer orders.

Finally, lines 9–14 have been deleted because under the stated rationale of the bill, it would no longer be needed upon the establishment of the national market system.

This in short reflects my antitrust concerns. They relate to the heart of the bill. And, for these reasons, I recommend that the Subcommittee not report S. 3126. In my opinion, it would do more harm than good.

APPENDIX A

SALOMON BROS.,
New York, N.Y., March 21, 1974.

Hon. PHILIP A. HART,
U.S. Senate,
Washington, D.C.

DEAR SENATOR HART: This is in response to your letter of March 15 requesting our comments on S. 3126, which would empower the Securities and Exchange

Commission to prohibit over-the-counter trading in listed securities under certain circumstances.

We have previously expressed the view that the competition provided to firms such as ours by third market dealers has created both an opportunity for sometimes better executions by our institutional customers and continuing pressures for constructive change in the securities markets. We have also stated that the absence of competitive barriers to dealing, as presently found in the third market, is a necessary characteristic of the central market system. Along with freely competitive dealing, the implementation of a composite tape, composite quotation system and comprehensive auction mechanism, as recommended by the Commission, would eliminate all important current differences between exchange trading and third market trading. In our view, this is the way to integrate the third market into the central market systems, and world be preferable to outlawing it. Finally, we have stated that we have no plans to resign our exchange membership after the advent of fully negotiated rates and have expressed disbelief that there would be a mass exodus of other exchange members. We still hold all of these views.

Although we doubt the need for the authority proposed to be granted to the Commission by S. 3126, it is difficult to quarrel with creating a "fail-safe" mechanism for the period between the advent of fully negotiated rates and the full implementation of the central market system by giving the Commission that power so that it could deal with any unanticipated emergency. We do, however, have certain suggestions for improving the bill to carry out its stated purposes:

(1) The bill would require the Commission to outlaw the third market if it makes the required findings. The Commission should be mandated to take such action if there is no other means within its power to deal with the problem. We suggest, however, that the Commission be expressly required to make such a finding as a condition to exercising its power under the bill.

(2) Even if there were mass resignations of exchange members, the exchanges would not cease to exist overnight. Any harm that had already occurred could still quickly be reversed by the Commission's action under the bill. Accordingly, this drastic action should not be allowed merely on the likelihood that reversible harm would occur. We suggest that the Commission be required to find at least that the specified adverse effects on the public interest had already begun to occur.

(3) The Securities Exchange Act is designed to foster self-regulation but not to prefer one self-regulatory organization over another. We suggest that the legislative history of the bill should state that the Commission may not make the alternate finding about "the ability of such exchanges to carry out their responsibilities under this title" merely because a particular exchange is losing members if they remain members of other exchanges and/or the National Association of Securities Dealers, Inc.

(4) We suggest that the legislative history of the bill should clearly indicate that the Commission may not make the finding about the absence of restriction on competitive dealing on exchanges (which should be stated in terms of necessity rather than reasonableness) unless exchange dealers are allowed to solicit and effect transactions directly with institutional investors, publish quotations even though they are not specialists and select the securities in which they effect dealer transactions. In other words, the only necessary change in the present trading operations of the new members should be the requirement that their transactions be brought to the floor for execution, thus being subject to the current rules of auction and reported on the ticker tape. Of course, the same opportunities should also be afforded to all present exchange members.

(5) Outlawry of the third market is likely to reduce the incentives for exchanges to push forward with the implementation of the central market system. Since action under the bill would be sought by the exchanges, we suggest that the Commission be required to find that they have proceeded in good faith and with sufficient speed to assist in the implementation of the system. The Commission should also have the power to vacate its action upon application of any interested person if this required finding, or any other under the bill, is no longer justified by the then circumstances.

(6) The factual basis for Commission action under the bill is likely to be hotly contested. In addition, any Commission action would be directed at a small, identifiable group of broker-dealers. We suggest that the Commission's action should be by order and only after an opportunity for hearings on the record.

(7) The bill would validate rules prescribing the sequence of execution not only as between members and the public but also as among members. We suggest that the statutory language itself or the legislative history provide specifically that such rules may not give priority to the orders of specialists over the orders of other dealers unless the Commission finds that the maintenance of the specialist system is necessary to preserve fair and orderly markets, and the extent of priority granted is necessary to preserve the specialist system.

If we can be of any further assistance to you in this matter, please let me know.

Sincerely,

WILLIAM R. SALOMON,
Managing Partner.

GOLDMAN, SACHS & CO.
New York, N.Y., April 4, 1974.

Hon. PHILIP A. HART,
U.S. Senate, Committee on the Judiciary, Subcommittee on Antitrust and Monopoly, Washington, D.C.

MY DEAR SENATOR HART: The purpose of this letter is to reply to the questions posed to me in your letter of March 29, 1974. In addition, I am enclosing a speech I made to the Institutional Investors Conference on March 18, which I believe will serve to amplify my answers.

Firstly, your characterization of my testimony in the *Thill* case was accurate. Secondly, Goldman, Sachs was a signatory of the "Lewis Ad Hoc Committee" letter of February, 1974.

Thirdly, Goldman, Sachs was never asked by anyone connected with the New York Stock Exchange whether it would leave the Exchange upon the advent of fully competitive commission rates, nor was Goldman, Sachs ever asked to express the opinion that it would leave the Exchange upon the advent of fully competitive commission rates.

Finally, as you will note in my enclosed speech, I have always contended that all securities transactions must be executed in a central market system such as that proposed by the SEC Advisory Committee on a Central Market System. The necessity that transactions in listed securities be confined to the national exchanges was an integral part of my position as a member of the Board of Governors of the New York Stock Exchange when we agreed to fully negotiated rates at our meeting in San Francisco last year. My belief at the time of the *Thill* case as well as today has been that fully negotiated rates will work to benefit the auction market *provided* that listed securities transactions be handled as described above. It is the preservation of the auction market which will provide the incentive to remain an Exchange member. Fully negotiated rates will not destroy that incentive if the regulation of the securities markets provides that all transactions in listed securities take place on the national exchanges.

I think it is important to point out to you as stated in my enclosed speech on page 6:

"My big worry is what *may*, and I underline may, happen when fully negotiated rates come into being. I worry that firms now members of national securities exchanges, the New York Stock Exchange particularly, may exit from the exchanges in droves. I ask myself, if one can obtain access to the New York Stock Exchange by hiring a floor broker or brokers for anything from, say $25,000 to $50,000 a year, why remain a member when one can use the exchange facilities when necessary at very little cost; otherwise, do one's business either as agent or dealer in one's office—not subject to the auction process and not subject to the rules and costs of exchange membership. What worries me is that a lot of firms will withdraw and become dealers in the 200 or 300 so-called "big stocks," thereby weakening the whole structure, particularly the other thousand stocks whose markets, even today, are not too robust, thus widening even more the so-called two-tiered structure."

These and other factors will have to be considered by a large number of firms including Goldman, Sachs with the advent of fully competitive commission rates.

Sincerely,

GUSTAVE L. LEVY.

93D CONGRESS
2D SESSION

S. 3126

IN THE SENATE OF THE UNITED STATES

MARCH 19, 1974

Referred to the Committee on Banking, Housing and Urban Affairs and ordered to be printed

AMENDMENT

Intended to be proposed by Mr. HART to S. 3126, a bill to amend the Securities and Exchange Act of 1934 to authorize the Securities and Exchange Commission to prohibit brokers or dealers from trading listed securities otherwise than on national securities exchanges in the event the Commission determines that such trading is contrary to the public interest and the protection of investors, viz:

1 On page 1, line 6, strike all after the enacting clause,
2 commencing with the words "'(e) (1)", through and in-
3 cluding the word "begins.'" on page 3, line 14, and insert
4 the following:

5 "(e) (1) Consistent with the other provisions of this
6 title, and if necessary to preserve fair and orderly markets,
7 the Commission may by rule prohibit brokers and dealers

Amdt. No. 1029

1 from effecting transactions in securities registered pursuant
2 to section 12 (b) of this title otherwise than on a national
3 securities exchange, if it finds, after notice and opportunity
4 for hearing, on the record, that (A) no rule or practice of
5 any national securities exchange unreasonably impairs the
6 ability of any dealer to solicit or effect transactions in such
7 securities for his own account or unreasonably restricts com-
8 petition among dealers in such securities or between dealers
9 which are specialists in such securities and dealers which are
10 not specialists in such securities and (B) as a result of
11 transactions in such securities otherwise than on a national
12 securities exchange the fairness or orderliness of the markets
13 for such securities has been or is in substantial probabilty
14 of being affected in a manner contrary to the public interest
15 and the protection of investors: *Provided, however,* That the
16 Commission shall adopt the least anticompetitive means of
17 preserving fair and orderly markets for such securities. The
18 Commission may conditionally or unconditionally exempt
19 any security or transaction or any class of securities or tran-
20 sactions from any such prohibition if the Commission deems
21 such exemption consistent with the public interest and the
22 protection of investors.

23 "(2) For the purposes of subsection (1) the ability of
24 any dealer to effect transactions in securities for his own
25 account shall not be deemed to be unreasonably impaired by

1 any rule of an exchange (i) fairly and reasonably prescribing
2 priority for orders of public customers brought to the ex-
3 change, or (ii) which has been adopted in accordance with
4 rules relating to priority of orders for public customers
5 promulgated by the Commission under this title.

6 "(3) The proceeding authorized pursuant to subsection
7 (1) may not commence until the rules of national securities
8 exchanges fixing rates of commission have been eliminated;
9 and any rule promulgated pursuant to subsection (1) shall
10 not remain in effect after the Commission has determined
11 that a national market system for securities has been estab-
12 lished, or April 30, 1978, whichever is earlier.

13 "(4) Any rule promulgated pursuant to subsection (1)
14 shall not become effective unless the Attorney General ad-
15 vises that such rule is the least anticompetitive means of
16 preserving fair and orderly markets for securities.

17 "(5) Nothing in this title shall preempt the applicability
18 of the antitrust laws to rules or practices of a self-regulatory
19 body or its members which have not been specifically man-
20 dated by the Commission."

Senator WILLIAMS. Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman. I would like to acknowledge the presence of the other members of the Commission, all of whom, I am sure, you have met.

From my right to my left, are Commissioners Pollack, Loomis, Evans, and Sommer. They are here not only because they are intensely interested in the subject matter of S.3126, but also because they might be helpful in supplementing my answers to the subcommittee's questions, or in providing answers if I cannot.

For the same reason, certain members of our staff are also here—Lee A. Pickard, director, Robert C. Lewis, associate director, and Andrew M. Klein, assistant director, of our Division of Market Regulation; and Harvey L. Pitt, my executive assistant—to provide any technical information that you may desire.

STATEMENT OF RAY GARRETT, JR., CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. GARRETT. Mr. Chairman, members of the subcommittee, at this subcommittee's request, I am prepared to discuss the Commission's views on several proposals for additional legislation, each designed to make explicit the Commission's authority, after making certain findings, to require that all training in securities listed on national securities exchanges be confined to securities exchanges registered with the Commission pursuant to section 6 of the Securities Exchange Act of 1934. At present, as the subcommittee is aware, listed securities also may be, and many are, traded in the over-the-counter markets, commonly referred to as the third market.

These legislative proposals are intended to respond to, and deal with, the argument raised initially by the New York Stock Exchange—that, if the elimination of fixed commission rates, which we have proposed occur on or before May 1, 1975, takes place prior to the implementation of a central, or national, market system, the Nation's auction trading markets could be seriously impaired, to the detriment of the public interest and the interest of investors.

The Commission, at the request of various members of this subcommittee and its staff, has set forth its basic position on the question before you today, as well as our suggestions concerning certain legislative proposals in this area, in a number of letters. I am submitting copies of that correspondence for the record, but I think it might be helpful to explain briefly what our general position has been and is on this difficult issue.

After a careful review of the arguments of the New York Stock Exchange, we advised this subcommittee last December that we had serious doubts that the sequence of events predicted by the New York Stock Exchange was likely to occur. We are still of that opinion. However, we recognized then and we recognize now that it is not possible to predict the future with certainty, particularly under conditions that have never existed before. We indicated our belief, to which we still adhere, that if the serious impairment of the markets, which the New York Stock Exchange fears will result from the elimination of fixed commission rates prior to the implementation of the central market system, were to occur or appeared likely to

occur, we could seek to prevent or remove such impairment by utilizing the full extent of the authority granted to us in S. 2519, as well as any other authority we have under existing statutes.

Nevertheless, since the question has been raised of our authority to take remedial action, we have supported the efforts of the staff and the members of this subcommittee prepare specific statutory language on the subject. Inasmuch as several drafts of proposed language are before the subcommittee, I would like first to discuss the issues as they appear to us, and then relate our views on the issues to the different approaches.

The first question is whether the Commission should have the authority by administrative action to cause all transactions in listed securities to be effected on a national securities exchange in every case or in specified cases, in whole or to a limited extent. Although the decision, whenever and by whomever made, will be a difficult one—and it is therefore tempting to urge the Congress to assume the burden—we think the complexity of the matter, the variety of techniques that might be employed to produce the desired result, and the exigencies of time and timing in the face of changing and unpredictable circumstances, throw the balance, in our judgment, toward putting the burden on the Commission.

The second question is what circumstances should justify or compel the imposing of restrictions on trading in listed securities. Should it be simply actual or prospective detriment to the public interest and the interest of investors, or something more precise? Since the proposed provision is directed to a spefiic possible problem, and a possible remedy, it would be well for the legislation to specify the nature of the problem with which it is concerned. In this respect, however, we favor identifying the impairment that is feared as that of our securities markets generally and not simply the effect upon any particular securities exchange or market. We realize that the largest existing market in listed securities is and is likely to continue to be the New York Stock Exchange. However, we think it more appropriate for the Congress to state the subject of its concern to be our markets generally and not limit its concern to that exchange.

The third question is the weight to be given to competitive factors in fashioning the remedy, assuming that the relevant impairment or threat of impairment has been found. In this regard, we have favored stating in the statute that the remedy of restricting trading to exchanges cannot be imposed unless exchange rules at the time do not unreasonably impair the ability of nonmember firms to solicit or effect transactions for their own account. On the other hand, we think it would seriously hamper the Commission in fashioning an effective remedy for the benefit of our securities markets if the remedy had to meet the test of being the one among all possible remedies that would produce the least anticompetitive effect. Still more would this be true, if our decision under such a standard was subject to concurrence by the Attorney General.

A fourth question is one of the appropriate time at which the proceedings preliminary to a decision under this provision can or should take place. We believe that the proceedings should neither be premature nor come too late. We have a reluctance, which I am sure the members of the subcommittee share, to make such important economic

decisions on estimates and forecasts of future effects. On the other hand, we have no intention of urging that we be required to wait until if this should occur, the worst fears of the New York Stock Exchange have come to pass, before we could take effective action. It therefore seems to us, if we are to have the responsibility to resolve this question, we should also be given flexibility as to when we begin our inquiry into the problem, and when we resolve the questions presented.

Now, turning to the various proposals that are before this subcommittee, let me discuss first S. 3126 as submitted by the chairman of the subcommittee, and Senators Brock and Cranston. That bill would require the Commission to prohibit brokers and dealers from effecting transactions in listed securities otherwise than on a national securities exchange if the Commission makes specified finding with respect to the effect of exchange rules on securities dealers and on competition and with respect to impairment of the fairness and orderliness of the exchange markets or the functioning of exchanges.

We have already submitted detailed suggestions to this subcommittee and its staff for the revision of a legislative provision which is virtually identical to S. 3126. In essence, our major difficulty with S. 3126, as presently drafted, is that we do not believe the Commission should be legislatively compelled so to restrict trading in listed securities, but rather, we believe that the elimination of nonexchange trading in such securities should be one of the options available to the Commission, if we become convinced that action should be taken to avoid or correct significant injury to the securities trading process. The use of the word "shall" in S. 3126, in setting forth our authority to act, could be construed as placing an affirmative burden upon the Commission to act in the manner set forth, even though other alternatives might be more appropriate. For that reason, we believe the word "shall" should be changed to "may."

Similarly, the description in S. 3126 of the findings the Commission must make before adopting appropriate rules is troublesome. We believe that the viability of fair and orderly markets generally, not just the existence of fair and orderly exchange markets, should be the determinants upon which Commission action is predicted. In our letter to Chairman Williams, which I have referred to earlier, we set forth suggested language changes to accomplish this goal.

Another proposal before this subcommittee is one submitted by Senator Tower, originally intended as an amendment to S. 2519. Senator Tower's proposed amendment would make clear that the Commission's authority to act on this matter is granted in permissive, rather than mandatory, terms, which, of course, we favor. Senator Tower's proposal, however, would permit Commission action to deal with any impending crisis only if it could first be demonstrated that the public interest and the protection of investors were "substantially certain to be" adversely affected in the absence of such action.

We believe that this proposal may be overly restrictive. Substantial certainty with respect to future events is difficult to attain. We, therefore, prefer the "is likely to be" language in S. 3126.

The next proposal, numbered amendment 1029, is the one Senator Hart introduced on the floor of the Senate on March 19. Senator Hart's proposal has two features with which we must differ. In the first place,

it would require the Commission to hold "on the record" hearings. The effect of this as a matter of procedure and in the light of the requirements of the Administrative Procedure Act, would be to convert what is a quasi-legislative policymaking determination into a trial-type adjudication complete with cross-examination. We believe this procedure is inappropriate and unduly burdensome and productive of delay.

Secondly, under Senator Hart's proposal, no Commission action could be taken unless the Attorney General advises that it is the least anticompetitive means of preventing fair and orderly markets for securities. No standards and no time limits are provided for this determination, nor is the Attorney General called upon to, in any way, balance the interests of the public in having the best possible markets against anticompetitive considerations. Given these two features of Senator Hart's proposal, if it should become law, I seriously doubt whether the Commission would be able to act at all, or, if we could act, whether we could act in time to stave off any impending crisis. Moreover, we do not believe it is sound policy to give the Attorney General complete discretion to veto the rulemaking of an independent regulatory agency simply because he believes it should have been formulated differently. We, therefore, believe Senator Hart's proposal should be rejected.

As I stated earlier, there is an additional problem with respect to timing in all three of the proposals. S. 3126 and Senator Tower's proposal provide that no rule could become effective until rules of exchanges fixing rates of commission have been eliminated. Senator Hart's amendment would provide that the proceeding for determining whether there should be a rule could not commence until that time. We prefer the approach in S. 3126 and Senator Tower's proposal, provided that it is clear that we are not, and cannot be, compelled to resolve the matter in advance of the unfixing of commission rates.

Both S. 3126 and Senator Tower's proposal would preclude us from extending the life of any rule we did adopt beyond May 1, 1978 unless we first gave the Congress 90 days notice of our intention to extend the rule. Senator Hart's proposal would not provide for any extension beyond that date. We believe that Senator Hart's proposal would unduly hamper our ability to deal with unforeseen developments when they arise and to continue to deal with them so long as is necessary in the public interest. We would also urge consideration of elimination of the 90-day notice provision as impeding emergency action, in favor of extensions from year to year with concurrent notice of each extension.

Finally, we understand that the Treasury Department proposes to suggest a different approach which has much attraction. The Treasury proposal would provide in essence, that if we find that the fairness or orderliness of the market for listed securities has been adversely affected by transactions on an exchange and in the third market, we shall take such action as may be required to eliminate or mitigate these consequences and would specify alternatives, including the prohibition of third market trading in whole or in part. While this proposal would identify the type of problem with which we would be called upon to deal, which is the one which concerns the New York Stock Exchange, it would not mandate a specific approach, which we

might find inappropriate, but would simply require us to take appropriate action and would specify possible approaches. We believe that the Treasury approach would avoid the problems which we have discussed above, including the problem which concerns Senator Hart, of calling for action which could be unnecessarily anticompetitive. We, accordingly, support the Treasury's approach, subject, of course, to its being embodied in statutory language.

That, Senator Williams, concludes my prepared statement. We are here to answer any questions you may have.

Senator WILLIAMS. Thank you very much, Chairman Garrett.

First, I would like to deal with the situation as it is with respect to the rules regulating third market activities, but before I do that, let me make certain that I understand the last paragraph of your statement. Correct me if I'm wrong, but am I right in understanding that you are suggesting, as one of your options, the elimination of the third market?

Mr. GARRETT. Yes, as a possible, statutorily-authorized but not mandated, alternative.

Senator WILLIAMS. Where is the New York Times editorial? I specifically want to make reference to it because it contains some language that does not apply at all to the Commission as I know it today. The article reads as follows:

> Though the present Chairman of the SEC, Ray Garrett, Jr., has taken a bold stand in promoting anti-competitive reform, this was not always true of his predecessors and it may not survive his tenure.

Have you seen the editorial in today's Times?

Mr. GARRETT. Yes, I did. I thought it was an unfortunate and inappropriate attack on my predecessors.

Senator WILLIAMS. Well, prior to that, it comments on Senator Hart's position as an opponent—I'll read the paragraph for the record.

> The measure's opponents, including Senator Philip Hart of Michigan, argue that this seemingly innocuous provision has the potential of becoming a Trojan horse—one that could allow the major stock exchanges to halt the ongoing reform process. It could open the way to years of litigation and filibuster before a pliable Securities and Exchange Commission, while the established exchanges reassert monopoly control over how securities are traded and by whom.

There is a gratuity in here too. They are hypothesizing the possibility of pliable Commission. But, reference to the elimination of the third market in your statement did rather startle me.

Mr. GARRETT. I do not know whether it is semantics, Senator. The idea—that the Commission be empowered to restrict trading in exchange-listed securities to national securities exchanges—originated, in legislative terms, from this subcommittee, and has been in each of the comments we have submitted to you since, at the least, last December. We, on the other hand are not advocates of the need for such legislation. We think S. 2519 and existing law would permit us to treat the problems to which S. 3126 is directed.

Senator WILLIAMS. Let's deal with the third market for a moment, particularly the inequalities of the rules. For instance, there are no rules, at least that I am aware of, regulating the activities of dealers in the third market with respect to the many areas in which there are clear and demanding regulations on the exchanges.

First, the obligation to maintan a fair and orderly market. Why isn't there a rule now?

Mr. GARRETT. Because the so-called third market does not give or award any monopoly franchises, as are received by exchange specialists, and thus there is no present need for such a rule.

Senator WILLIAMS. Are there rules applicable to the third market regarding market manipulations?

Mr. GARRETT. That is the law. It does not require a separate rule. The third market and all markets are already bound by such restrictions. It is true that the stock exchanges have specific rules for this, but it is equally true a specific rule is unnecessary. In any event, uniform rules governing market manufacturers are under preparatory, to coincide with the implementation of a consolidated tape.

Senator WILLIAMS. The protection of public orders?

Mr. GARRETT. Third market dealers do not receive public limit orders. It is the law, of course, that, if they do, they cannot trade against them. There are judicial decisions to that effect. But, Third Market dealers do not receive public limit orders. They receive market orders from other brokers.

Senator WILLIAMS. But there is nothing prohibiting them from receiving public orders.

Mr. GARRETT. No.

Senator WILLIAMS. They certainly have a great deal of business from institutions, banks——

Mr. GARRETT. They do have business from institutions. I am not aware that it is a significant amount where compared to volume on the New York Stock Exchange.

Senator WILLIAMS. And from insurance companies.

Mr. GARRETT. And other brokers and public investors.

Senator WILLIAMS. We also consider that to be a significant part of public business.

Mr. GARRETT. And other brokers, who may well act, and often are acting for other individuals.

Senator WILLIAMS. Is there anything in the way of rules or regulations requiring the disclosure of transactions?

Mr. GARRETT. Yes and no. There is no requirement for the real time disclosure—the disclosure of transactions as they occur—because there is no vehicle to accomplish it. They are required, if they participate in NASDAQ—the National Association Security Dealers Automatic Quotation service—to make periodic daily reports of the volume of their transactions. But, they do not report transactions as they occur in the fashion that does occur with respect to transactions on the New York Stock Exchange. They will do so, of course, with respect to certain exchange-listed securities, when the consolidated tape comes into operation. That is one of the purposes of the consolidated tape.

Senator WILLIAMS. Another area in which I sense inequality is short selling. Are there any rules or regulations directed to the third market on short selling?

Mr. GARRETT. No, there is no present short-selling rule comparable to that applicable to exchange, but we have proposed one. This is in connection, again, with the forthcoming consolidated tape. We have published for comment a proposed short-sale rule that would govern third-market participants as well as exchange markets. I might add, of course, that third-market participants are subject to the same rules as everybody else if they should put their trade on an exchange.

Senator WILLIAMS. Do you see the need for equal regulations in the third market as the marketplace evolves?

Mr. GARRETT. Yes, but only as it is evolving. As Commissioner Loomis likes to observe, "Equal regulation of the unequal is inherently unequal." The central market system that we have in mind would bring competition onto an equal basis. And with it will surely come relevant and appropriate equal regulation. This is very much a part of the course we have outlined, and in which this subcommittee has concurred.

Senator WILLIAMS. Will that be contemporaneous with the central market system?

Mr. GARRETT. Well, the various facets of the central market system are not all going to come into being at one time. The first major step toward it, putting aside the unfixing of Commission rates, will be the implementation of the consolidated tape—the tape reflecting historical securities transactions, as you know.

All the participants and the Commission have agreed that, when the composite tape goes into effect, there should be equal regulations governing manipulative conduct, short sales, and rules that you have not mentioned yet, trading talks. You have not mentioned talks, presumably because the context where such rules might be necessary does not yet exist under present circumstances.

These are the regulatory factors that we have agreed should be equalized before the tape becomes operational and we will have adopted then by the time this tape is physically ready to begin.

Senator WILLIAMS. But the first fixed point of significant change will be April of next year when the Commission has announced clearly and irreversibly that the fixed commissions across the board will be eliminated.

Mr. GARRETT. That is scheduled for the end of April. May 1, 1975, will be the first fully unfixed day, by which time, of course, we expect to have the consolidated tape in full operation.

Senator WILLIAMS. Do you expect that the rules and regulations you are now in the process of developing dealing with the third market will be in effect, in whole or in part, by that date?

Mr. GARRETT. I expect that rules on the three subjects I have mentioned will be in effect on that date. These are the only rules we believe are relevant to the consolidated tape. Now, the other rules with respect to operating in the full central market system under the program, as we envision it, are keyed in to the adoption of a composite quotation system, and certain other rulemaking developments that must occur. I cannot say with certainty that that is going to occur by May 1, 1975. I think the New York Stock Exchange would agree that, if we were all certain they would occur by May 1, 1975, we wouldn't be here today. They have stated that, if all the components of the central market system were in existence on that day, they would not have this problem and would not be seeking this kind of relief. But, we do expect it to be in place as soon thereafter as possible. And, of course, ideally, it would be in operation and in being so at that time this problem would never actually arise. I can't promise that that is going to be the case.

Senator WILLIAMS. It is that lack of certainty that brings us to the consideration of this bill. It appears that the time gap between the

elimination of fixed commission rates and the installation of the national market system may operate, according to the NYSE, to furnish incentives to firms to relinquish their exchange memberships. Part of the incentive, I would imagine, would be the lack of equal regulations in the third market.

Mr. GARRETT. Well—you mean weighed against the protection of the fixed commission?

Senator WILLIAMS. Exactly.

Mr. GARRETT. Possibly. Many have asserted they could make more money off the exchange. But, if they really thought they could do so, they would be there now.

Senator WILLIAMS. Well, these firms obviously want to protect their businesses, and I am certain that they are now in the process of evaluating a number of factors bearing upon the business judgment whether to operate on an exchange or elsewhere. One factor under consideration would be the New York Stock Exchange's recently announced reduction in rates for some orders——

Mr. GARRETT. No; that was a member firm of the New York Stock Exchange, and it will not start until next week. It will start on Monday.

The question of equal regulation does not affect many members directly. We are talking about the regulation of specialists as opposed to the regulation of third market markets. Members of the exchange have the obligation to put their transactions on the exchange; that is true. For this, they now get the benefit of charging a fixed commission.

Senator WILLIAMS. That's the point, Mr. Chairman. When there are no longer fixed rates, and there are no regulations in the areas we have been discussing, you can theorize that part of the incentive to leave the exchange would be to escape the exchange pattern of regulation and become a freewheeler in a relatively unregulated market.

Mr. GARRETT. I don't see that at all, Senator.

Senator WILLIAMS. Well, I may not either, but this is a theory that has been advanced by responsible spokesmen and I believe it warrants our attention.

Mr. GARRETT. That's not the way they explained it to me.

Senator WILLIAMS. They may not use the word "freewheeler" but I think the message that is communicated is clear enough. It is that less regulation means more opportunity.

Mr. GARRETT. They do not even talk about the lack of regulations; they talk about the money they are going to make off the exchange. It is not because of lack of regulation that they threaten to leave the exchange; it is because of the spread they think they can charge for making dealer markets and tracking from their own inventory.

Senator WILLIAMS. We have already been over this briefly. But perhaps we can take some specific examples where there is a conspicuous absence of third market regulation—short selling is a standout. Shortselling on down ticks is possible in the third market, is it not?

Mr. GARRETT. They will not be able to do so.

Senator WILLIAMS. We're talking about making money, aren't we?

Mr. GARRETT. It is a good way to lose money.

Senator WILLIAMS. Well, I've never been asked to sell short but,

there are some successful short sellers. Nevertheless, the advantage is that there is no rule or regulation applicable to short selling in the third market.

Mr. GARRETT. By May 1, 1975, we will have a short sale rule in effect that will apply to the third market.

Senator WILLIAMS. Another example occurs in the context of the phrase that has guided our markets for so long—fair and orderly markets. Will there be a rule in effect by that date also governing the market making conduct of those in the third market?

Mr. GARRETT. Not in the sense you presumably mean, although over-the-counter markets must be fair and participants in those markets are regulated. Unless, of course, at that time we are significantly further along toward the central market system. And of that I am not certain.

Senator WILLIAMS. You can see the arguments that are advanced that would suggest the need for SEC residual authority to deal with any situation arising between the unfixing of commission rates and that day when the national market system is plainly visible and operational.

Mr. GARRETT. Certainly. And S. 2519 would give it to us. Your suggestion is that an alternative, limiting trading in listed securities to the New York Stock Exchange, as opposed to the third market that does not now exist. That is one of the flexibilities that we want to be able to apply, if it should be necessary to do so.

But, that is one reason why we do not favor a bill that offered only a single remedy to the potential disintegration of the auction market.

Senator WILLIAMS. I am aware of the correspondence that you mention and the language changes that you suggest in this bill. Are these other alternatives suggested as amendments?

Mr. GARRETT. No. We don't need them as amendments, since we already have that authority in S. 2519 and existing law. But their absence should not imply that we do not desire to be relieved of any compulsion to apply only one remedy—namely, restricting all of the transactions of the New York Stock Exchange—as the only way in which we can prevent people from removing their trades from the exchange.

Senator WILLIAMS. This is not legislation that deals with one exchange. Rather, the intent is clear enough on the face of the bill that there is to be general applicability to exchanges.

Mr. GARRETT. Which has led us to comment, in our earlier letter, that the relief sought might not work anyway. If all third market makers went to the Cincinnati Exchange, for example, it might make a limited difference to the New York Stock Exchange. But it is true that this bill would apply to all exchanges. And the requirement set forth could be met by putting the trade on any exchange on which the security is qualified to be traded, and not necessarily on the New York Stock Exchange.

Senator WILLIAMS. Could we be kept advised of the status of developments in the regulations I have discussed with you today concerning the third market? I think it would be helpful for our consideration of this detail if, within 30 days, the Commission prepared a status report on its efforts to develop an equitable regulatory framework.

[A letter was received from the SEC at a later date. It may be found at p. 171.]

Mr. GARRETT. All right. As you know, Senator we are in the process of appointing an advisory committee, to be chaired by Mr. Alexander Yearly IV, chairman of the Robinson-Humphrey firm in Atlanta, whose task will be to advise us on moving from where we are now to the full central market system. And we are anxious for you to get acquainted with him. We are developing a program with him that will involve equal regulations as well as a number of other matters. We will certainly report to you within 30 days, and as often thereafter as we have any news.

Senator WILLIAMS. I appreciate that.

Just to recap some of your specific suggestions for this legislation; you recommend that "shall" should be changed to "may"?

Mr. GARRETT. Yes.

Senator WILLAMS. That would give you greater flexibility.

You say that "exchange" markets, should be deleted and replaced to describe markets in general. Frankly, I am not sure I understand that.

Mr. GARRETT. The markets in general, as we develop the central market system, and particularly as other regulatory and mechanical devices come into play, should be the dominant factor, and not just what occurs on the stock exchanges. Right now they sound like the same thing but I don't know what they'll sound like a year from now.

Senator WILLIAMS. Thank you, Senator Biden?

Senator BIDEN. Thank you, Mr. Chairman.

Mr. Chairman, I want to make sure I understand what you are saying.

The thesis of what you're saying is that you don't anticipate any rush from the floor to the third market to begin with. However, if that unanticipated event were to occur, you want the flexibility to deal with the situation; is that correct?

Mr. GARRETT. Yes.

Senator BIDEN. If you don't anticipate with any degree of likelihood that there will be a substantial decline in exchange membership, then isn't it a bit too soon for Congress to write a so-called fail-safe provision in the bill?

Mr. GARRETT. Well, our initial thought was that it did not need separate and express acknowledgement. We believe that the powers otherwise granted to us by the Securities Exchange Act, as it now stands, and the amendments to those powers that will be provided by S. 2519, will give us sufficient authority to take various steps to cope with the problem.

However, the problem was brought into public debate by the request of the New York Stock Exchange, initially, when it suggested that trading in listed securities be limited to registered securities exchanges by statute. We did not think that was a good idea because we did not think the probability of their fears coming to pass was sufficiently great. Not because we believed that their fears could not create a problem, but because we think that they should not. The discussions then led to something that did not seem to be intelligent, that is to say, that the act was going to talk about this problem in a restrictive manner. It would be better to talk about it in terms of giving the administrative agency the authority to fashion appropriate relief

and take appropriate measures if the fears we have heard so much about should actually come to pass.

Senator BIDEN. What are those conditions which would evidence the fact that the fear has come to pass?

Mr. GARRETT. I think a wholesale defection of traders away from the New York Stock Exchange could be a very alarming development.

Senator BIDEN. What does that really mean? Does that mean that the membership would drop off 20 or 25 percent, or 50 percent, or 80 percent?

Mr. GARRETT. I do not mean to be facetious, Senator. If I had a clear idea as to exactly where the line lay, I would suggest that you put it in the statutes. But, I do not. Other variables exist at the same time. I suppose, from an economic point of view, I would have to say, that a state or point could be reached that would affect the markets to a significant degree, if trading and liquidity in a significant number of stocks on the floor became so thin that we ceased to have an auction market in those stocks at a time when we had not yet gone far enough toward developing the equivalent of an auction market in the central market system.

I must say, we are also concerned with the financial well-being of the New York and other stock exchanges. We need them as part of our overall regulatory program. We could not get along without them for a lot of reasons, although there are many other ways to help finance exchanges.

Senator BIDEN. I'm not really trying to nail you down. but I'm trying to point out for the record that it is a difficult line to draw where these fail-safe provisions would take effect and I'm concerned that perhaps the bill should be drafted to try to describe more clearly what that situation would be.

Mr. GARRETT. That is what leads us to prefer a proposal that we did not think of ourselves—the Treasury Department's proposal—which, I am sure, Mr. Schmults will more thoroughly explain. The virtue of that proposal is that it starts out by defining the problem. It does not start out, as S. 3126 does, by defining the remedy. Of course, we have not seen any specific language. Then the Treasury proposal provides that, if these fears are coming to pass, or are very likely or substantially certain to pass, the Commission shall take certain steps to remedy the situation, choosing from various alternatives.

Senator BIDEN. I'd like to see a little more about that, too.

Senator WILLIAMS. Thank you. Senator Bennett has to leave, so if we could interrupt for a moment, it would be appreciated.

Senator BIDEN. Surely.

Senator BENNETT. I'm just interested on the bottom of page 2 you indicate on the bottom line that you have other authorities under existing statues under which you can act. Do you mind identifying some of those for the record?

Mr. GARRETT. We have authority under section 19(b) of the Securities Exchange Act, in effect, to compel the adoption of rules by registered securities exchanges in a rather broad list of areas. While our authority over members and nonmembers of exchanges is pervasive, it is not comparable in all respect to the authority we have with respect to exchange members. In some cases, it is broader; in others, it is cast in different terms. One thing that S. 2519 would do that

does not now exist would be to expand and make comparable all of our exchange and nonexchange member authority that would be helpful. However, there are other ways in which some aspects of this problem could be approached. For example, rules treating this issue could be adopted under the general fraud provisions of our statutes.

Senator BENNETT. That might be going around Robin Hood's barn instead of directly to the heart of the problem.

Mr. GARRETT. It would be helpful to have our authority made explicit, as S. 2519 would do.

Senator BENNETT. What rule changes do you anticipate in the New York Stock Exchange or that they would have to make to meet the requirements of section (e.) (1a) of S. 3126?

Mr. GARRETT. Let me be sure that I have the right section. One rule, in particular. If third market firms were to be given competitive specialist positions on the New York Stock Exchange, Rule 113 of the New York Stock Exchange presently would forbid their doing business directly with institutional investors which, of course, is their principal business.

Senator BENNETT. That rule would have to be changed?

Mr. GARRETT. In some respects; otherwise, to bring the third market firms on to the exchange would drive them out of their separate marketmaking businesses. I understand it is not the intent of S. 3216 that that should be required.

Senator BENNETT. Mr. Chairman, I'm sorry, I'm very sorry, but I have to go. Thank you for yielding to me, Senator.

Senator BIDEN. If I may follow up with my line of questioning. We agreed that it's difficult to determine what would constitute the demise of the exchange, but I have found broad disagreement on this point.

Mr. GARRETT. It sounds familiar.

Senator BIDEN. Because of the great uncertainty as the effects of this legislation, I have been told that I will destroy the exchanges without it, but that I must really be in the pocket of the exchange in order to support it. I think it is legitimate criticism by those in the third market who say that if you leave this provision wide open, you're avoiding your congressional responsibility. You're writing an act and if you're going to be one of the legislators, you cannot do that. I don't believe it is proper for Congress to, as it so often does, delegate all the authority to anyone it can find to take it. Now that's a very open ended question, but I would like you to try and respond, if possible.

Mr. GARRETT. It runs to the very heart of the matter. Without trying to psychoanalyze what any of the various participants in this matter really want, however, and taking their arguments at face value, there certainly appears to be some substance to the arguments. I suppose the New York Stock Exchange, for one, might say: "This danger is real, and if you wait until you can see it, it will be too late. You have got to prevent it from occurring to begin with. The only way to prevent it is to prevent it now, and Congress ought to take the responsibility." I know third market makers would say exactly the opposite thing: "There is nothing to the Exchange's argument and to create this temptation is to ensure that we will end up dead on the floor in the process."

It is our opinion at the Commission that, notwithstanding the criticism of some, that there has been too much delegation of power

to administrative agencies; this is one area which should be delegated to the agency that has been given responsibility of regulating our markets and taking appropriate action. It is a very complex subject, to be sure. Anyone that sits here today and thinks he can say exactly what the market will look like, structurally, to say nothing of price and volume, a year and a half from now, is kidding himself. We do not know and they do not know. We guess and they guess. We think our guess is better than theirs and vice versa. There are too many other things moving at the same time that are likely to change circumstances: regulatory matters and procedures, electronic capabilities, market habits and many other variables.

I think the decision on these issues should be left with the responsible body whose full-time job it is to keep up with and try to understand these matters, with guidance from the Congress, of course, as to the parameters within which we should act.

I think the bill tries to do that. Both versions do. We should preserve as much competition as possible and still bring forth a decent auction market law with standards that we can understand.

Senator BIDEN. Thank you, Chairman Garrett, for your response to my vague and general questions. What I'd like to do now is be a little more specific. Now, you say you want more flexibility?

Mr. GARRETT. Yes.

You say you want the flexibility to go beyond the requirement that all trading in listed securities be confined to exchanges.

Mr. GARRETT. Short of requiring all trading in listed securities to occur on an exchange, not beyond.

Senator BIDEN. Thank you. Can you give me some specific examples of alternative action the Commission might take if the Congress were to provide more flexible rule-making authority in this area?

Mr. GARRETT. Do you mean the types of things short of restricting all transactions in listed securities to registered exchanges?

Senator BIDEN. Right. If you could list some for me.

Mr. GARRETT. One possibility that has been suggested, and publicly discussed, would be for us to require that third market firms check the market on the New York or other stock exchanges before executing orders for other customers.

Senator BIDEN. When you say "check," what specifically do you mean?

Mr. GARRETT. Find out quotations from exchange specialists and whether such quotations are better than those offered elsewhere and dispose of these orders in a way which would clear the specialist's book. This is one possibility. Another is to say that if anybody is making a third market in a listed security, as Professor Ratner has suggested, they should not deal with the public but only with dealers on a wholesale basis. This would discourage the major retail firms from leaving the exchange in order to integrate forward into making markets in listed securities. That is a possibility. Exposure of public orders over the NASDAQ system, for example, is another possibility. That would make possible an auction. It certainly would expose such orders to a wide audience of possible takers. Things of this kind, and ideas that we have not yet thought of, might help the situation.

That is the sort of thing about which we have thought.

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Senator BIDEN. What would be the position of fourth market firms if the provisions of S. 3126 were to take effect? Would they be put out of business?

Mr. GARRETT. I think at the moment the real fourth market would be left untouched. S. 2519 would give us authority to reach them, I believe. Mr. Robert Lewis, Associate Director of our Division of Market Regulation, can add to this discussion.

Mr. LEWIS. To the extent that trades occur between individuals who are not registered with the Commission as brokers or dealers, S. 3126 would not reach them. The Commission would have no authority, under S. 3126, to require such transactions to be effected on an exchange.

There is, however, a grey area with regard to some participants in the fourth market because there is some confusion of terms. Instinet, for example, is sometimes classified as a fourth market participant. Nevertheless, Instinet is a broker-dealer registered with the Commission, so that its trades would have to be taken to an exchange under S. 3126, absent some exemption. That fact may very well put Instinet, or any similar electronic system, out of business. Brokers that handle crosses between institutional clients are sometimes classified as being in the fourth market, but they are broker-dealers registered with the Commission.

To require that transactions by broker-dealers in listed securities be taken to an exchange probably would also put those persons out of business, again absent some sort of exemption.

Senator BIDEN. Should S. 3126 be enacted, what burden do you think would be placed on the third market firms? Would there be any?

Mr. GARRETT. Well, there would be no burden until we acted pursuant to the authority granted. The burden, until we did act, would be the uncertainty as to what we might do. When we did act, it would depend on our actions.

Senator BIDEN. It would depend on your actions?

Mr. GARRETT. Yes; it would depend on our actions. I do not mean to be facetious, but, even if we took full advantage of the authority granted to us to require all transactions to go on an exchange, the exact details of the requirement would define the extent of the burden. It would depend upon what the access rules would have to be to meet the requirements of the bill. This might not prevent their doing their own business directly, but it certainly would at least require them to expose all of their business to the specialist's book to give the public an opportunity to participate in their trades.

The public does not have an opportunity to participate in third market trades now—as the exchanges would be quick to tell you.

Senator BIDEN. In discussing S. 3126, we have been told that one of the purposes of it is to avoid "chaos" in the auction markets. What do you envision as "chaos?"

Mr. GARRETT. I have not heard the term "chaos." I have heard the term "drying up" or "disappearance of" the auction market and the takeover of the auction market, by dealers conducting business "upstairs," as the street calls it, rather than down on the floor. This need not be chaotic at all. In fact, the over-the-counter, or "third," market could be quite orderly. It does not, however, have the virtues attributed to an auction market and we take these virtues seriously. Among

these virtues are the possibility of protecting public orders, permitting them to participate in trades, and to some degree, the price or value setting mechanism of the auction market, which seems to be more believable or to have more credibility when it takes place down in an auction crowd rather than elsewhere. But, that does not mean the third market is chaotic; rather, simply that it is one kind of market rather than another.

Senator BIDEN. I guess by the choice of the term chaos, you don't have to guess who I've been talking to.

Mr. GARRETT. No.

Senator BIDEN. S. 3126 would require that anticompetitive rules of the exchange be eliminated before the directives can be carried out. Would you please comment on the necessity of eliminating the following rules of the New York Stock Exchange: First, rule 113 which prohibits specialists from dealing directly with certain kinds of customers.

Mr. GARRETT. If third-market makers, as a result of requiring their trades to be effected on an exchange, were to be given positions as specialists, alternate specialists, or something of that sort upon the exchange, rule 113 would forbid them from dealing directly with institutions as well as corporate insiders; that would drastically change the business of third-market firms in a manner inconsistent with the standards set forth in the proposed bill.

Senator BIDEN. Rule 438 which prohibits market makers other than specialists from quoting two-sided markets in a security.

Mr. GARRETT. It is a little hard to know exactly how it would work. If the power under the bill were used simply to require third-market firms to become members of the stock exchange, and they had to send all of their transactions to the floor, then, of course, they would have to stop their activities off the floor, which would stop two-sided quotations in the third market altogether. Rule 438 would have to be modified to permit them to do it.

However, I don't think rule 438, in its present form would be considered consistent with the anticompetitive standards set forth in the bill.

I must say again, in case it is not clear, that these are representative of the kinds of decisions that the Commission would have to make in an appropriate way if the bill's authority ever were to be used. I do not mean to be understood as foretelling what the decision might be.

Senator BIDEN. The intent of this question is not to put the exchange or the Commission in a corner to promise future actions. But I am trying to analyze these provisions to make it clear for the record.

I think it's worthwhile to give a broader picture of the possibility of what might occur.

One further part of this last question, Mr. Chairman. We are talking about the requirements of S. 3126 that anti-competitive rules be eliminated. Would there [also] be a [need to] eliminate membership on the exchange on a medallion basis.

Mr. GARRETT. Yes; restricted membership would have to be eliminated. Whether it would have to be eliminated for everybody or whether alternative concessions could be made to third market firms is something different to predict, but one can hardly imagine that the only solution or remedy under S. 3126 is that third market firms

would be required to obtain full membership on an exchange as the concept of membership is now understood.

Senator BIDEN. Thank you very much, Mr. Chairman, and thank you, Mr. Garrett.

Senator WILLIAMS. Let me return to the statement you made a moment ago, Mr. Chairman, limiting ourselves to the New York Stock Exchange. I believe this is very important to the bill. You favor identifying the markets generally. We are not singling out any particular exchange market. We realize that the largest existing market in listed securities is likely to be the New York Stock Exchange. However, you think it is more appropriate for the Congress to state the subject of its concerns, to be our markets generally, and not to limit its concern to that particular exchange.

We discussed earlier a lot of the anxiety expressed by that exchange. The language of the legislation, however, is to exchange, is it not?

Mr. GARRETT. Correct.

Senator WILLIAMS. I do not fully understand the market "generally" that you refer to. Perhaps there is an unknown market?

Mr. GARRETT. Or some changes in the third market not now present.

Senator WILLIAMS. It is my understanding this can be clarified within our bill to make clear that it is the auction markets that we are interested in preserving and protecting. In fact, the exchanges too would have us address ourself to this point.

On page 2, line 10, it has been suggested to change that line to read "the fairness or orderliness of the auction market for such securities."

Mr. GARRETT. We didn't say auction markets in our version; I don't know where that came from.

Senator WILLIAMS. My understanding was that this was your suggestion. Perhaps, I misunderstood my information, but I thought this was the result of a staff level discussion.

Mr. GARRETT. Our proposal should have read: "Fairness or orderliness of the markets for such securities." We would simply delete the phrase "such exchanges."

Senator WILLIAMS. Yes, the word auction is included in there. "Auction markets for such securities * * * or the ability of the exchanges to carry out their regulatory responsibilities * * *."

Mr. GARRETT. That was not one that we had recommended, sir.

Senator WILLIAMS. How does it strike you? This was not unilateral from here, as I understand it. It's been a staff matter, and it's bilateral, yours and ours.

Mr. GARRETT. Yes, we discussed it, but we did not include it in the recommended versions. You ask me what we think about it now?

Senator WILLIAMS. Yes.

Mr. GARRETT. I would prefer, again, that the relevant universe of concern be the total state of our market.

Senator WILLIAMS. To make clear that we are talking about the role of auction markets.

Mr. GARRETT. Well, like everything else, it also relates to the whole business. What we do not want is a situation in which, because there is some decline of trading on the New York Stock Exchange and some increase in third market trading, we are compelled to restrict all trading to stock exchanges.

Senator WILLIAMS. I don't believe that version.

Mr. GARRETT. Do you want to look at the overall health of the markets, or just of the auction markets, to use that term?

Commissioner LOOMIS. I think the problem with the use of the term "auction market" is that neither the New York Stock Exchange nor the over-the-counter market is a 100-percent auction market today. Definition of an "auction" market or a "dealer" market is difficult, while the term "market" encompasses both.

It was our desire to encompass and preserve both kinds of markets.

Senator WILLIAMS. Now, your broader phrase, then, would be to use the phrase "markets" rather than with any specificity or descripition?

Mr. GARRETT. That is our recommendation. Yes, sir.

Senator WILLIAMS. That is all I have.

Mr. GARRETT. May I ask if any of the other Commissioners would like to supplement anything that I have said?

Senator BIDEN. Mr. Chairman, may I ask one final question? I believe that the third market now provides a competitive force to stock exchange specialists by the competing markets it provides for certain listed securities.

Wouldn't that competitive force by definition be eliminated by a requirement that all trading in listed securities be confined to exchanges?

Mr. GARRETT. Yes, we would restrict or eliminate the third-market maker's ability to compete with the specialist in market making to the extent that the third market maker had to take his order to a specialist, like anybody else, and subject himself to the specialist's book, if not to the specialist's own bids.

The degree to which this would happen, I think, would depend upon just how it was worked out, the worst thing, from the third-market maker's point of view, would be to require him to become a member of an exchange under present exchange rules and requirements. Nobody contemplates that because it would be inconsistent with the standards already set forth in S. 3126. The least disruptive action, I suppose, might be to require their orders at least to be exposed to the specialist's book. It could be anticompetitive, I'm sure.

Senator BIDEN. Is it fair to say that such a move could be made and still have a competitive situation?

Mr. GARRETT. I think so. I do think it is possible. I would like to make it very clear, particularly because of one of your opening questions, Mr. Chairman, that it is not our intention or desire or target to act under this bill. Our target is the central market system within which the third market will compete in a thoroughly integrated, fair, equally regulated system. The last thing we want to do is exercise the full authority proposed under something like S. 3126. But, as a matter of honesty, I have to say this is one of the alternatives that ought to be available to us.

On the other hand, we do not think it ought to be the only alternative available, which is what we are afraid S. 3126 does.

Senator WILLIAMS. S. 3126 does not repeal any other authority delegated to the SEC?

Mr. GARRETT. But by using the word "shall," S. 3126 provides the basis for an argument that, if we find a decline in the auction markets, and if the other conditions in the bill are met, we must restrict all trading in listed securities to exchanges. We are further worried about the timing implied by the bill because of the word "shall," and I hope

the record will very clearly show that this decision need not be made before commissions become unfixed, if S. 3126 becomes the law, as I stated in my testimony.

Senator WILLIAMS. That's clear but on the other question of whether this displaces all the authority that you have suggested you have, we do not disturb that. But you believe that the mandate of "shall" is the thing that could cause some displacement. Is that right?

Mr. GARRETT. The use of the word "shall" does not displace our other authority. But, if we make the findings S. 3126 contemplates, then I think someone could argue to a court that we have to grant this relief, if relief is the right word to call it; we do not want to have to do it. We want to be able to make these findings and use other measures short of this if they will do the job for that reason, we believe the statute should use the word "may," to avoid any ambiguity and to preclude this argument from even being made.

Senator WILLIAMS. Under the bill, the Commission would make the findings that serve as the basis for the provisions of this bill going into operation. In other words, the Commission must make certain findings?

Mr. GARRETT. Yes.

Senator WILLIAMS. Do you have any partnership in that? Would you have a court sharing your responsibilities?

Mr. GARRETT. Well, first of all I think we would have to be honest in making the findings and we could not refuse to make them just because we did not like the relief that such findings would bring about.

Second, of course, our action presumably would be subject to some judicial review, to a degree, with the word "shall."

With the word "may," we could not be compelled to take any action.

Senator WILLIAMS. In an effort to correct any emerging adverse situation in its incipient state, you could use other power and authority conferred by law, before invoking the remedy prescribed by this bill. Am I correct?

Mr. GARRETT. I do not want the bill to provide a basis for anybody to say that we are compelled to hold hearings and to resolve this matter before commission rates become unfixed, because I know the consequences of that. It will drag on and the next argument will be that we must postpone the unfixing of commissions, and that is the kind of delay a court might require of us under S. 3126.

Senator WILLIAMS. Well, we didn't say anything about putting this into operation before commission rates are unfixed.

Mr. GARRETT. You don't say it, but I think, sir, that you are providing a foundation for this kind of trouble.

Senator WILLIAMS. I don't think there is any authority in the Commission in this bill to act before commission rates are unfixed.

Mr. GARRETT. It says we should restrict trading to exchanges if there is likely to be any significant harm to the auction markets.

Senator WILLIAMS. As I undersand this bill, it is directed to the period of time after commission rates are competitively determined.

Mr. GARRETT. It only hinges on a finding that there is likely to be harm after commissions are unfixed.

Senator WILLIAMS. I am glad we had this discussion.

Mr. GARRETT. If you made it clear that this is not the intent, that at least would help.

Senator WILLIAMS. Well, that is why this is the best of legislative practices. Thank you, Mr. Chairman.

Mr. GARRETT. Thank you very much.

Senator WILLIAMS. Our next witness is the General Counsel of the Department of Treasury. We will come to order because we have a vote almost upon us.

STATEMENT OF EDWARD C. SCHMULTS, GENERAL COUNSEL, DEPARTMENT OF THE TREASURY, ACCOMPANIED BY DAVID STOUGHTON, STAFF MEMBER

Mr. SCHMULTS. Mr. Chairman, members of this subcommittee, my name is Edward C. Schmults. I am the General Counsel of the Treasury Department. The Department is very pleased to have this opportunity to present its views to you today.

Present with me is David Stoughton, who is a member of the Treasury staff. He's sitting on my right.

As you know, the Treasury has taken an active interest in the various legislative proposals for reforming the structure and regulatory system of our securities markets. We feel that the prospects of achieving the common goal of a vigorous and healthy national market system, operating in the public interest, can only be enhanced by a broadly based consideration of the troublesome questions involved.

It was with this view that the Treasury commissioned Prof. James H. Lorie to prepare the recently distributed statement entitled "Public policy for American capital markets." Secretary Shultz, Deputy Secretary Simon and others at the Treasury and other Federal agencies devoted considerable time to the series of discussions leading to that statement. Secretary Shultz wanted to be here today but he had to be enroute to the Inter-American Development Bank annual meeting in Chile. The testimony I am giving today reflects the views of the Treasury Department.

We hope to work constructively with the Congress, the Securities and Exchange Commission, the financial community and others in the development of securities legislation which so vitally affects the economic fiber of the Nation. Accordingly, I welcome this opportunity to address the subject of the role of the third market in a national market system, and more specifically the question whether the Securities and Exchange Commission should be given a specific grant of power to prohibit third market trading, in whole or in part, in the event adverse consequences appear as we move under a competitive rate structure toward the creation of a national market system.

The bill now before the committee, S. 3126, provides, in effect, that the SEC must prohibit third market trading, in whole or in part, if it finds after notice and apportunity for hearing that, as a result of third market transactions the fairness or orderliness of exchange markets or the ability of exchanges to carry out their responsibilities under the Securities Exchange Act of 1934, has been or is likely to be affected in a manner contrary to the public interest and the protection of investors.

Before addressing the merits of S. 3126, let me briefly explain Treasury's views concerning the role of the third market in the national market system. We agree with the SEC that a key objective of

a national market system should be to promote the development of strenuous competition among market makers. Such competition can greatly increase the depth and liquidity of our securities markets by maximizing market-making capacity, that is, the ability and willingness of dealers to buy and sell securities for their own accounts when the other side of a specific order is not readily available. In a competitive environment, market makers have greater incentive to bid higher or offer lower than competitors in order to attract business. This competition benefits the public by narrowing the spread between available bids and offers and enabling investors to buy for less and sell for more. Third market firms provide an important source of competition to specialists, block positioners, and other market makers, and thus make significant contributions to market liquidity. Assuming that these firms are subject to the same basic rules and regulations which apply to other market makers in the system, we see no reason to require them to join an exchange in order to conduct business, absent the development of adverse consequences from third market trading.

The New York Stock Exchange initially took the position that competitive rates combined with a new national market system that permits third market trading will threaten the demise of the auction market process for buying and selling listed securities. Therefore, it urged that S. 2519, recently reported out by this committee, be amended to prohibit third market trading. As we understand it, the Exchange's concern was based on the following line of reasoning. The advent of competitive rates and a national market system that includes the third market will remove virtually all incentives for exchange membership. According to the exchange, the resulting loss of membership will threaten the viability of the exchanges as trading centers and diminish the effectiveness of their regulatory role. If the exchanges are thus weakened, the exchange argument continues, the auction-agency principles we seek to preserve could not be sustained.

This committee rejected the New York Stock Exchange's proposed amendment, and with good reason we believe. For it is not reasonable to presume that the advent of a national market system that includes the third market and a competitive rate structure will lead to the decline of trading floors and specialists who operate on them. If, as we and others believe, the auction market system of the New York Stock Exchange and other exchanges possesses inherent efficiencies, the exchanges should continue to attract a substantial flow of orders in the competitive environment of the new national market system.

Furthermore, even if the exchanges were to become less important, many of the essentials of the auction process would be preserved in the proposed national market system. In the new system, market makers, whether specialists on the floor, block positioners, or third market firms, will compete so that potential buyers and sellers can easily know the best bids and offers in the market at any time. The composite quotation system, a key element of the new system, will provide the technology to achieve this competition. Any [broker] holding a customer's order will be able to insert a bid for [or offer to sell] stock into the composite quotation system through a market maker.

The order, if the best bid [or offer] held by that market maker, would be displayed throughout the entire system and could be executed against either another dealer's offer [or bid] or the order of another

public customer submitted by his broker through any other market maker. Thus, even without an exchange floor, the system would allow public orders to be offset inside the dealer's spread without the intervention of a dealer. Public orders would be protected against the execution of any transactions in the system at an inferior price by an auction trading rule which would prohibit execution of any transaction at a price less favorable than that offered or bid by a public customer. Thus, we believe that the new national market system will contain the essence of the auction process.

With the rejection of the New York Stock Exchange's proposed amendment to eliminate the third market, the focal point of controversy has shifted to the effects of third market trading during the period of transition to a national market system. The concern here is that the introduction of competitive rates prior to the implementation of the national market system could erode and destroy the auction market system of the exchanges by diverting a significant volume of orders from them during the transitional period. We do not feel this concern is justified. Even if competitive rates come into effect prior to the development of a national market system, there would appear to be little likelihood that a significant volume of orders would be diverted from the exchanges. Until a national market system is installed with its central electronic book, limit orders should continue to be placed with exchange specialists for execution, enhancing the depth of exchange markets and thus attracting additional orders. Furthermore, with competitive rates, there would appear to be less incentive for institutional investors to channel their business to the third market and the regional exchanges to save commission dollars. In fact, the elimination of fixed commissions could increase the volume of transactions on the primary exchanges.

We believe the powers granted to the SEC in S. 2519 are adequate to deal with any unfairness or disorderliness which the third market might cause on our exchange markets. However, at the same time, we recognize that the stakes are high and uncertainties do exist. Therefore, while Treasury defers to the views of the Department of Justice with respect to the possible anticompetitive aspects of S. 3126, we would not be opposed to providing the SEC with a specific grant of authority to take appropriate action should the feared consequences arise from the operation of the third market.

If the committee decides that such specific authority is desirable, then the Treasury believes that the central objective of the bill can best be attained by taking an approach somewhat different from that set forth in the bill.

In its present form, the bill first prescribes a specific and inflexible remedy and then requires that the SEC apply such remedy if it finds that certain conditions exist. Various conflicting views have been, and will be, expressed about how, when, and under what conditions the remedy should be invoked. The controversy is sharp because the mandated remedy is harsh. We believe that the approach taken in the bill may have contributed to the controversy. In attempting, on the one hand, to assure that the SEC possesses clear congressional authorization to invoke the remedy specified in S. 3126 or, on the other hand, to circumscribe and restrict its use by the SEC, some of the parties interested in the bill, we suspect, may not be focusing their attention

on the problem which concerns this committee. In our view, it is possible to achieve a commodious solution by first defining the problem with which the bill attempts to cope and then directing the SEC to take appropriate action in the event it occurs.

Following this line of thought, we suggest that the bill be revised to provide that if the SEC finds, after a hearing, that transactions in securities registered pursuant to section 12(b) of the 1934 act, both on a national securities exchange and in the third market, have affected the fairness or orderliness of the markets for such securities in a manner contrary to the public interest and the protection of investors, then the SEC shall—and I underscore "shall"—take such action as may be required to eliminate or mitigate the adverse consequences. Cast in this form, the bill could specify that one of the administrative remedies available to the SEC is the prohibition of third-market trading, in whole or in part. This should comfort those who fear that the SEC may conclude that broad general grants of authority in S. 2519 are not adequate to impose a remedy as harsh as a complete prohibition of third-market trading. Our proposal would end the controversy over the use of "shall" or "may" in the bill. Parenthetically—this is not in my written statement—I would like to add that this proposal would also permit us to endorse the "likely to be" standard, rather than suggesting the tighter "reasonably certain to be" language.

The approach we are suggesting should also eliminate any concerns about the antitrust aspects of the proposed bill, as presumably the SEC would take into account the anticompetitive effects of any remedy which it fashions. The SEC would take only that remedial action which it deems necessary to restore fairness and orderliness to the markets for registered securities. Congress would not be prejudging the dimensions of the problem and imposing an unnecessarily rigid legislative solution. Rather, it would be directing that the SEC utilize its administrative expertise after the specified problem has taken shape and develop an effective remedy which is in the public interest.

We think this approach is consistent with the history of our securities laws and administrative law generally. It is more neutral in tone than S. 3126 and, in its generality, less antagonistic to the third market. The Treasury would be happy to offer its assistance to this committee to revise S. 3126 along the lines we have outlined.

Alternatively—and we find this alternative much less desirable than the one suggested a moment ago—at a minimum we urge that two changes be made in S. 3126 which are similar to those included in Senator Tower's proposals to amend the bill.

First, we would urge the committee to change the word "shall" to "may" in the first sentence of S. 3126. Rather than mandating that the SEC must prohibit third-market trading where it finds such trading adversely affects the public interest and the protection of investors, we believe that Congress should merely authorize this particular remedy and make its use discretionary on the part of the SEC. We feel it would be unwise to lock the SEC into an administrative straitjacket and mandate a harsh remedy for a problem whose dimensions can only be dimly perceived at best and which may well not occur.

If a problem is found to exist and third-market trading proves contrary to the public interest, it is quite probable that a solution other than the one proposed in S. 3126 will be more appropriate and more in the public interest. For example, the SEC might determine that

the appropriate remedy is to speed the implementation of the national market system so as to alleviate any adverse effects felt during the transition period.

With respect to our first suggested change, it should also be pointed out that the failure to give the SEC a good measure of administrative discretion could result in delay in the implementation of the national market system. However slight this effect may be, we should avoid creating disincentives to achieving the important task of establishing a national market system.

The second point we would make is that the legislative standards for triggering such a remedy should specify that the adverse consequences of third market trading must be clearly apparent before the drastic measure of eliminating such trading is to be taken. If a part of the securities industry is to be put out of business, we believe that the evidence should be hard, not flimsy. Therefore, we would urge that the committee substitute for the phrase "has been or is likely to be" the phrase "has been or is reasonably certain to be." While we are not wedded to the words "reasonably certain," we feel that the language "is likely to" is to imprecise and is susceptible to too loose an interpretation. We would welcome the opportunity to work with the committee's staff in drafting an appropriate standard.

In summary, we urge that this committee, in its consideration of S. 3126, follow the path of wisdom blazed over the years by Congress and permit the Securities and Exchange Commission to exercise its administrative expertise, and fashion, if the circumstances so require, an appropriate remedy to eliminate or mitigate a congressionally defined problem. For the reasons supporting our two specific suggestions for changes in S. 3126, we believe this committee should revise the bill along the lines we have indicated to first define the problem and then direct the SEC to deal appropriately with it if and when it arises.

Thank you, Mr. Chairman.

Senator WILLIAMS. Thank you very much, Mr. Schmults.

These last suggestions following your opening remarks are alternative approaches "We find this alternative much less desirable than the one suggested a moment ago." I assume that what follows is your second and less desirable alternative?

Mr. SCHMULTS. That's correct, sir.

Senator WILLIAMS. The first includes "shall," but then would allow for broad options, is that right?

Mr. SCHMULTS. Yes, sir. We would leave the remedy to the SEC. We said if the problem arises that we are concerned with, and I think your opening statement was absolutely right in this regard—we don't believe this is going to occur—nevertheless, it would be a very serious problem. If the problem does occur, there should be authority to deal with it. So if the defined problem does occur, then we would suggest that Congress tell the SEC that they must do something about it; but we would leave it to the SEC what to do, because we are not certain, and I don't believe anybody can be certain, if the problem does occur, what shape it will take and what remedy will be needed to cure the problem.

Senator WILLIAMS. Now, I appreciate that you indicate these actions should follow in mitigation of the adverse consequences. We have had general discussions and general questions here on just what these adverse consequences might be.

We hope, tomorrow, to get some flesh on the bones of the adverse consequences and clarify with some degree of specificity again what the possibilities are of adverse consequences.

I think that's a fair question to put to the proponents of fear, don't you?

Mr. SCHMULTS. I certainly do.

Senator WILLIAMS. Just one other question I had on page 9 with respect to the possibility of delay in implementation of the national market system if the SEC does not have a good measure of administrative discretion. I wonder if you could amplify that statement particularly the contingencies that might cause problems under those circumstances?

Mr. SCHMULTS. Yes, sir. I think as we have seen over the past several weeks, if the only remedy which the SEC can impose, as S. 3126 now provides, is to prohibit third-market trading, in whole or in part, we think that this will be a sharply contested hearing, a long, drawn out hearing. It may drain the resources of the SEC and others in the securities industry. We think that the efforts and energy here should be directed to the implementing and putting the central market in place.

In our view, if the SEC has some administrative discretion to fashion an appropriate remedy to cure the problem, the SEC will be able to move more rapidly and get on with the job of providing leadership in establishing the central market.

Senator WILLIAMS. Well, if that is the possibility, and you are quite persuasive, I would think that the very nature of the hearing that Senator Hart proposes in his amendment to this bill would lead to even greater delay. Do you follow?

Mr. SCHMULTS. Yes, we would agree with your approach, and that is to have a legislative hearing. We think that it is also consistent with our approach that the decision as to when the hearing is to be held should be left up to the SEC. It may then deal with conditions as they arise. We would not want to impose any fixed standard on the SEC in that regard.

So we are much closer; indeed, we are in accord with your position as to when the hearings are to be held.

Senator WILLIAMS. Obviously, you and the Department of the Treasury have spent a lot of time on this. Are you prepared to put into legislative language your ideas?

Mr. SCHMULTS. Certainly we have done this. We would be happy to present something to your staff if you desire.

Senator WILLIAMS. We will look forward to and appreciate it. Thank you for an excellent statement.

Senator Biden?

Senator BIDEN. Thank you, Mr. Chairman.

I have one broad question. In the beginning of your statement, you say, "And more specifically, the question whether the Securities and Exchange Commission should be given a specific grant of power to prohibit third market trading, in whole or in part, in the event adverse consequences appear," and you go on from there.

When I heard that, I assumed that you were questioning not whether or not they should be directed to exercise it, but whether or not they should even have power; and then you go on in your statement, if I

understood you correctly, to sort of acknowledge that they should have the power.

Can you clarify that for me?

Mr. SCHMULTS. Yes, I think the focus should be on the word "specific" there.

Our position on S. 2519, is that the SEC, if that bill is enacted, would have to deal with the problem. However, we are very conscious of the concern of the New York Stock Exchange that, if the SEC is to impose a remedy requiring prohibition of third market trading, as I understand it, the New York Stock Exchange would take greater comfort, and I certainly understand this, from seeing a specific provision in the bill which would authorize the SEC to take such action. We have no quarrel with that, even though we think the general powers in S. 2519 are adequate; but we do have a quarrel with mandating, as I said earlier, a harsh remedy. We would like to see the problems which concern the New York Stock Exchange and this committee identified and then leave it to the SEC to fashion an appropriate remedy.

Senator BIDEN. But you do see it as one of the appropriate alternatives recommended for the SEC to be used in their discretion?

Mr. SCHMULTS. That's correct. If there is chaos, whatever that may mean, and the only way to cure this, the only way to preserve the New York Stock Exchange, which over the years has been a superior market and has done a lot for our capital system, if that were the only remedy and the SEC decided in its administrative expertise that probihition of third market trading was what was required, we would see no problem with that. And so we would have the bill specify that this is a possible remedy.

Senator BIDEN. Thank you; I don't have any further questions.

Senator WILLIAMS. Thank you.

Mr. SCHMULTS. Thank you very much.

Senator WILLIAMS. We have Mr. Thomas Kauper, Assistant Attor-General, from the Antitrust Division of the Department of Justice.

Mr. Kauper, we will be interrupted with a call to go to the Senate for a vote scheduled for 3:30. We might as well get under way, just in the event that something goes awry over there. It is not expected, but once in a while it happens.

Mr. Schmults has indicated that the two Departments have been in communication on this.

Mr. KAUPER. We have indirectly, Mr. Chairman.

Would you like me to go into my statement first and then respond?

I think the record should show, Mr. Chairman, that I am accompanied by Mr. Barry Grossman, who is Acting Deputy Assistant Attorney General to the Antitrust Division.

STATEMENT OF THOMAS E. KAUPER, ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, DEPARTMENT OF JUSTICE, ACCOMPANIED BY BARRY GROSSMAN, ACTING DEPUTY ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION

Mr. KAUPER. I am pleased to respond to this committee's request for the Department of Justice views on S. 3126 and proposed amendments to that bill offered by Senators Tower and Hart. S. 3126 would empower the SEC, under specified circumstances, to restrict the trad-

ing of listed securities to national securities exchanges, that is, to abolish the third market. The proposed legislation appears to be based on the concern that, at least prior to the implementation of a national market system, the potential for third market trading under a fully competitive commission rate system will cause the demise of the primary exchanges.

This concern was first expressed by the New York Stock Exchange (NYSE) which proposed that S. 2519 be amended to require that all trading in listed securities be limited to the exchange markets. The Department expressed its opposition to the NYSE's proposal in a letter to this subcommittee, dated December 11, 1973. Subsequently, the Department was requested by Senator Philip A. Hart to comment on two draft proposals, one of which has now been introduced as S. 3126, which would grant the SEC authority to eliminate the third market under certain circumstances. We expressed our views on the subject in a letter to Senator Hart, dated February 25, 1974, a copy of which was furnished to the chairman.

In our letter of February 25, we stated that in the Department's view, there is not sufficient reason to grant the SEC the authority to eliminate the third market. The administration's position, based upon its recently completed study of the capital markets, is reflected in the testimony of the Treasury Department.

I would first like to address myself to the question of whether there is a present need for conferring upon the SEC the power to prohibit third market trading. Third market trading is not a recent phenomenon the likely consequences of which are presently unknown to Congress or the Commission. It is a method of doing business which over the years has not caused any demonstrable public harm. On the contrary, the existence of the third market has provided significant public benefits in terms of affording a means of avoiding the anticompetitive trading restrictions of registered exchanges. Indeed, the Chairman of the SEC has stated to this subcommittee that the third market has been an "important source of competition in the securities market." In view of the public benefits afforded by third market trading, we do not believe that Congress should confer upon the SEC the authority to prohibit such trading absent indications that it is likely to pose a significant threat to important public interests in the future.

We are currently aware of no evidence which would substantiate the claims of the New York Stock Exchange that the potential for third market trading under fully competitive rates will seriously endanger the public interest in fair and orderly securities markets. In a letter to this subcommittee, Chairman Garrett has stated that there is "little chance" that a significant volume of orders will be diverted from the primary exchanges upon the elimination of fixed rates prior to the implementation of a central market system. We have reached the same conclusion on the basis of evidence introduced in the *Thill* case. The evidence introduced in that trial indicated that fixed rates on the exchanges were responsible for a significant amount of the trading that is now done in the third market, and that much of this trading might return to the exchanges if fixed rates were eliminated. The evidence introduced in that trial also indicated that the primary incentive for membership on the NYSE is the right of direct access to the trading floor. In view of the superior order flow on the ex-

changes, the prestige factor of exchange membership, and the various service benefits offered by the exchanges, we believe that any concern that third market trading will result in a significant impairment of the exchanges' ability to provide necessary services to the public can only be branded as highly speculative. We do not believe that Congress should grant the SEC the extraordinary authority to prohibit third market trading, which has been publicly beneficial, because there is some remote possibility that such trading might harm the primary exchanges.

The elimination of third market trading would appear to be inconsistent with one of the principal objectives of S. 2519 which is "to foster competition among market makers to the extent consistent with the protection of investors and the public interest." S. 2519 appears to provide the statutory framework which would enable the SEC to accomplish this objective. Thus section 18 of the bill vests the SEC with authority to eliminate or prevent restrictions on access and entry into the exchange market which constitute a "burden on competition not necessary or appropriate" to the purposes of the act. Similar authority is conferred upon the Commission to assure broker-dealer access to stock quotation and stock transaction information, which is a prerequisite for the functioning of a national market system. Section 6 of the bill confers upon the Commission the authority to require an "open book" accessible to all market makers and to require that limit orders anywhere in the system be fully protected as to priority and preference. Finally, in section 11, the SEC is granted authority to assure equal regulation and responsibilities for market makers irrespective of whether they operate on an exchange. Thus, the subcommittee has already attempted to provide the SEC with adequate authority to promote competition among market makers with adequate protection for the public.

It has been suggested that enactment of S. 3126 would provide an incentive for the exchanges to eliminate anticompetitive rules and restrictions on competition between market makers. Apparently, it is believed that the exchanges would voluntarily take such action in order to persuade the SEC that no rule on a national securities exchange unreasonably impaired the ability of any dealer to trade for his own account, or unreasonably restricted competition among dealers in listed securities or between specialists and dealers who are not specialists. We wish that we could share that viewpoint. However, we cannot. S. 3126 does not specify which presently existing exchange rules are unreasonably restrictive, therefore it does not require that any particular present restrictions be abandoned. The past disinclination of the exchanges to abandon restrictive trading rules prevents us from believing that the exchanges would, on their own, quickly rid their rules of all unreasonable restrictions absent clear congressional directives. In any event, the SEC in S. 2519 has been given substantial powers to remove unreasonable burdens on competition between markets makers.

Senator WILLIAMS. I wonder if we could pause here and recess for the vote.

[Whereupon, at 3:30 p.m., the hearing was recessed, to reconvene at 4 p.m., this same day.]

Senator BIDEN. May the hearing come back to order, please.

I am acting chairman in that Senator Williams is unavoidably detained for a few minutes; and he will be back.

Possibly you can pick up where you left off, Mr. Kauper, in your statement.

Mr. KAUPER. We recognize that one might reasonably feel that since no one can be omniscent about the effects of future changes, it would do no harm to provide the SEC with appropriate fail safe powers, even if it was felt that such powers would never have to be used. However, we believe that enactment of S. 3126 might do some harm. It is possible that the creation of such standby authority could operate as a disincentive to achieving the principal goal of S. 2519—the creation of a national market system in an expeditious manner. An invitation to the exchange community to request the SEC to use the power that would be conferred upon it, an invitation likely to be accepted, may misdirect the energies of the industry and the Commission away from the establishment of composite tape and quotation systems, clearing and settlement procedures and other steps necessary to the development of a national market system. Uncertainty as to whether third market trading will be allowed in the future would, of course, complicate and delay these steps necessary to the effectuation of a fair and efficient national market system.

A principal reason for the introduction of S. 3126 appears to be the belief that if an unexpected danger to the public interest should arise from third market trading under competitive rates, the SEC would be able to act in a more expeditious manner than Congress. On considering the comparative question of expeditious resolution of an unforeseen adverse effect upon investors, we merely observe that the complexity of the issue is evidenced by the manner in which S. 3126 has been drafted. The bill would not authorize the SEC to act on the occurrence of events the existence of which would be subject to simple empirical observation. The Commission would be required to hold a hearing and to make difficult findings as to whether any existing exchange rule unreasonably impairs or unreasonably restricts dealer opportunities to trade for their own account or competition between various types of dealers. Moreover, the Commission would have to make findings to the effect that third market trading had or was about to affect, in a manner contrary to the public interest, the fairness or orderliness of the exchange markets or the ability of the exchanges to carry out their responsibilities. These are not simple issues subject to quick and easy determination. Presumably, any Commission decision would be subject to judicial review and possible remand to the Commission. As a result, final Commission action under S. 3126 would be expected to take a considerable amount of time, and rightfully so. The safeguards which have been placed in S. 3126 are hardly superfluous. The drafters of the bill, and others who have proposed to amend the bill, recognize that important issues are at stake for all parties concerned, and that such safeguards are necessary to provide assurance that any Commission action would, in fact, serve the public interest.

Let me now respond to your request for our views on the provisions of S. 3126 and the related amendments proposed by Senator Tower and Senator Hart. If the subcommittee concludes that the Commission should be granted amnesty to eliminate the third market, we strongly urge that S. 3126 be revised in several important respects.

There are five proposed amendments to section (e)(1) of S. 3126 that we feel should be adopted. First, both Senators Tower and Hart proposed that the Commission be given the discretion, rather than mandated to eliminate the third market upon making the requisite findings. We believe that such an amendment should be adopted. Both the SEC and the Department of the Trearsury have stated a similar view. Clearly, the SEC should not be compelled to eliminate the third market if in its judgment there is an alternative means of satisfying the goals of S. 3126 which would impose a lesser restriction on competition. Second, we strongly support amending S. 3126 in a manner proposed by Senator Hart to require the SEC to adopt the least anticompetitive means available to preserve fair and orderly markets. We can conceive of no public policy justification for allowing the SEC to eliminate third market trading if the policy goals of fair and orderly markets can be secured by less anticompetitve measures. There is just no reason to countenance an unnecessary limitation upon the competitive benefits afforded by third market trading.

Third, we feel that the SEC should not be authorized to eliminate third market trading upon finding a mere likelihood that adverse consequences may occur. Senator Tower has proposed that the word "likely" in clause (B) of section (e) (1) be replaced by a "substantially certain" test and Senator Hart has recommended a "substantial probability" test. Secretary Shultz has recommended substituting the words "reasonably certain" for the word "likely." The thrust of these three proposals is that the word "likely" provides too superficial or general a standard for judgment or belief for action which should be taken only upon concrete and specific evidence that the market will be impaired. In view of the severity of the action to be taken and the need to provide a more concrete standard for judicial review, we believe that a stricter standard is necessary. Consequently, we support the amendment proposed by Secretary Shultz.

Fourth, we support the amendment proposed by Senator Hart that would require a hearing "on the record" in connection with a proposed rule to eliminate the third market. We observe that in S. 2519 there are at least six instances in which the bill requires the Commission to conduct a hearing on the record. The common denominator for these diverse provisions is the requirement for a full evidentiary type of proceeding when the Commission, pursuant to its authority, must decide on matters limiting or prohibiting the activities of the affected party, which in turn could have a profound impact on the party's operations. These provisions affect, among others, all self-regulatory organizations including national stock exchanges. The authority granted the Commission in S. 3126 to eliminate the third market is at least comparable to its authority in section 18 of S. 2519 to withdraw the registration of an exchange. We believe that third-market makers are equally entitled to a full hearing before the SEC on a matter concerning their very existence as an independent competitive force.

Finally, we support Senator Hart's proposed deletion of the language in clause (B) of section (e) (1) of S. 3126 in which the fairness and orderliness of the markets is identified exclusively with the exchange markets. The effect of the deletion would be to require the Commission to evaluate the overall ability of the markets—including the third market—to serve the interests of public investors. We believe that this standard is consistent with the policy expressed in this sub-

committee's report in which public investor interest is identified with "stable and orderly markets with maximum capacity for absorbing trading imbalances without undue price movements." The report expressly rejected a choice between "auction" and "dealer" markets, which we believe is the implication of clause (B) as presently drafted. In this respect, we note that the SEC apparently agrees that the determination of whether fair and orderly markets for trading listed securities have been adversely affected should not be limited to exchange markets.

Senator Hart has proposed several other amendments, the adoption of which would, in our opinion, clearly serve the public interest. He has proposed amending section (e) (3) of the bill to prohibit the Commission from initiating a rulemaking proceeding until fixed rates have been eliminated. S. 3126 as presently drafted would allow the SEC to issue a rule prohibiting third-market trading on the very day that fully competitive rates on exchanges are effected. As we indicated in our letter of February 25, we feel that the SEC should not be allowed to eliminate third-market trading in the absence of evidence that the combination of fully competitive rates and third-market trading has caused or is about to cause serious public harm. Such a significant restriction on a method of doing business which has been publicly beneficial to date should not be allowed on the basis of conjecture as opposed to actual market experience.

We also support Senator Hart's proposal to insert language at the beginning of section (e) (1) of S. 3126 to provide that any Commission rule to eliminate the third market must be "consistent with the other provisions of this title." We interpret this clause as a means of subjecting S. 3126 to the strictures of S. 2519. We view S. 2519 as a mandate to the SEC to foster competition, and therefore we believe that any decision of the Commission to eliminate a "substantial" source of competition among marketmakers must be based on the conclusion that an independent competitive market is incompatible with the objectives of S. 2519. In addition, we believe that Senator Hart's proposed amendment to section (e) (2)—in which the phrase "priority for orders of public customers" would be substituted for the term "sequence"—provides preference and price priority for public investors.

Proposed section (e) (5) reaches beyond the specific objectives of S. 3126 to codify what this subcommittee has recognized as the prevailing law—that volitional anticompetitive rules or conduct of self-regulatory organizations are immune from antitrust attack only if they are found by an appropriate court to be necessary to make the statutory scheme of securities regulation work, and then only to the minimum extent necessary. We agree with this interpretation of the law and feel that enactment of section (e) (5) would provide a clear statutory expression of congressional intent.

I hope, Mr. Chairman, that this expression of the Department of Justice's views will assist this subcommittee in determining the best course of action to take on this important issue. We will, of course, by happy to provide any further assistance that the subcommittee desires.

Thank you, Mr. Chairman.

Senator WILLIAMS. Thank you very much, Mr. Kauper. Looking back over the years, we have been grateful indeed for the vigilance and enlightened views of the Department on so many issues. We appreciate your being here on this issue, as well. While you are not in general agreement with the Treasury on some areas of the administrative side of the Government, or with the SEC, I am sure that your input will be useful.

I didn't have the benefit of the continuity of your statement, so I will defer to Senator Biden.

I appreciate Senator Biden's taking over.

Senator BIDEN. Thank you.

I would say that I think you made a very good case in the first nine pages of your statement for no legislation on this point but then you went ahead and seemed to say "Congress ought to do something but it will be anticompetitive, and as long as it is anticompetitive the Justice Department had better do the responsible thing."

Now, it seems to me that you would have made your case very well if you started on page 9. Do I understand that you didn't mean what you said on the first nine pages?

Mr. KAUPER. Now, let me explain.

Our invitation from the chairman specifically asked us to address a number of amendments which we tried to do on the assumption arguendo that some such legislation would be enacted.

I think I should add, Mr. Senator, that the administration position is that of the Treasury Department, which has testified preceding me, so I don't know that I would read our feeling that there is no need for the legislation and our comments on legislation as inconsistent in view of the fact that we felt we should comment on the amendments which have been offered.

Senator BIDEN. Let me see if I do understand that your preference would be for no amendment whether it be Hart, Tower, Williams; whomever. You think that the act as now drafted, S. 2519, is sufficient as far as you are concerned; is that correct? There is no need for any of this legislation?

Mr. KAUPER. Well, Senator, in answering that question, I think we have to ask sufficient to what end that is; if the question is would it be sufficient to accomplish everything which this bill would give the SEC, I think there is some serious doubt about that.

Senator BIDEN. Good point. In your opinion, would it be better not to have any of the proposed amendments to S. 2519 because they would have anticompetitive or potential antitrust implications?

Mr. KAUPER. When you say the amendments to S. 2519, I am not quite sure what you are referring to, Mr. Senator.

Senator BIDEN. You can tell that I am dealing with the Justice Department and not the Treasury any more. I will try to be as specific as I can. It's been a long time since I have been in court.

In the first 9 pages or of your statement, you made, what seems to me, to be a case for the position that to allow even the discretion to reside within the SEC to eliminate the third market would be a violation of the law, that it would not be a power you would want to see vested with the SEC.

Mr. KAUPER. Well, certainly we have raised doubts about it, yes, Senator.

Senator BIDEN. OK, let us try it again. Would you rather the SEC not even have discretion under any circumstances to eliminate the third market? Would that be your preference?

Mr. KAUPER. I think if I may put it in terms of my personal view, that would be it. Yes, sir.

Senator BIDEN. Now, I assume that is not the official position of the Department?

Mr. KAUPER. No.

Senator BIDEN. I don't have any more questions.

Senator WILLIAMS. I'm a little troubled about your conclusion on the possibility of delay in implementing the national market system and that S. 3126 would effect the Commission's implementation of the national market system. It seems to me that Senator Hart's approach and method in dealing with this issue would add many years of delay in achieving that system, and in coming to a conclusion on the S. 3126 situation. If there is a problem of causing a delay, it would seem that the Hart proposal, which you support, would exacerbate the situation.

Mr. KAUPER. Well, let me comment on that. I think that the thrust of our testimony, at least the doubt that we raise, is in substantial matter on the question of delay, but it seems to me if a decision is made to leave the option open to the SEC, that once that decision has been made with the attendant possibility of delay which that in and of itself may create, that then it becomes necessary or should be the case that the hearing should be a full hearing.

Now, I think I would have to concede, Senator, that that may add some additional element of delay to it, but I think consistent with the circumstances of S. 2519, where that sort of hearing is called for, this is a similar kind of judgment which is being called for, and I think I view it more as a question, if such a decision is going to be taken, of how one best gets the information and best protects the rights of those who do, after all, have a rather distinct involvement in this question. But I think I would have to conclude that a full evidentiary hearing may be somewhat slow. I think that's true.

Senator WILLIAMS. Does the evidence that will be produced at this kind of a hearing lend itself to the opportunity for cross-examination? Aren't these really policy judgments?

Mr. KAUPER. Well, I think, Mr. Chairman, that depends to a degree on what one anticipates the issues are going to be. The statute as proposed is not altogether clear here on what sort of inquiry, for example, one would have to make to determine whether this unreasonably restricts competition.

Obviously, how one perceives the issues depends upon your judgment here. It depends on that, but I think in the way the bill is presently drafted there will, for example, likely be testimony on what firms intend to do, what firms intend to leave the market.

That, it seems to me, is certainly a question which is appropriate for cross-examination.

Senator WILLIAMS. Well, it would seem to me that it is certainly an easy factual situation. It doesn't lend itself to too many questions of credibility and so forth. They are either exchange members or not members. They are dues-paying members or they are not. There are certain questions as to whether small investors have an auction market.

For example, where they just cannot get their orders to buy or sell executed. That's the orderly market.

Now, that, I suppose, lends itself to some kind of a forum for evidence taking.

Mr. KAUPER. Yes, I think that's possible.

Senator WILLIAMS. How would you describe a market that is not orderly? One in which people cannot get their orders taken?

Mr. KAUPER. Yes, that certainly is one possibility.

Senator WILLIAMS. One in which members are leaving the exchanges and there is an erosion of the auction market and only a dealer market remains?

Mr. KAUPER. Well, I think obviously when we have what is sort of a word of art, in which nobody is quite sure what the meaning is, such as orderly market. One of the experiences we have had in this kind of issue was during the *Thill* trial where we had considerable testimony about intentions of firms with respect to the market. We had a great deal of expert testimony, and I think that an examination of that record would very likely show the great merit of cross-examination with respect to this testimony.

Now, perhaps I'm being overly leery and that was, of course, a trial, but it's still a question of facts and a question of opinion in terms of expert testimony where it seems to me that type of procedure is very worthwhile.

Senator WILLIAMS. Frankly, it was not on our minds to have a remedy here that is of an anticompetitive nature. The requirement that all listed securities be traded on an exchange and other provisions of the legislation specifically designed to insure that third market makers could conduct their customary operations on an exchange marketplace, would preserve this kind of competition. Do you think that this is not our intention?

Mr. KAUPER. Well, I think our concern with respect to the effect on competition can be put on two somewhat different levels. First, there is, I think, within your question, an assumption that the action taken by the SEC pursuant to this bill, if it were taken, would be after a determination that there were no significant restraints remaining on competition between dealers and so on.

Senator WILLIAMS. Yes.

Mr. KAUPER. I think in a purely practical world because those criteria are not defined that sharply in the bill. There is some question as to how the SEC would resolve those issues, and whether one would truly have a completely competitive situation.

The second is a concern, I think, for the——

Senator WILLIAMS. You see some ambiguity?

Mr. KAUPER. No; I don't think I would say that on the record of the subcommittee's bill as such. I think I see it in the sense that we're being asked to project whether the SEC would find, when it is asked to make a determination, that a particular rule does or does not unreasonably impair competition. I do not know what rules that would involve or what kind of judgments the SEC would make on those issues, and whether they would end up with a situation which was truly competitive, would ultimately depend on their resolution of those issues and their administrative proceedings.

I think the second concern would be for the third market, itself. As I recall, Senator Biden asked this question of Chairman Garrett, whether this would have some kind of anticompetitive consequences. I think his answer was, "Yes." I would have to concede that it might, and as I recall the discussions the emphasis there was on the fact that the third market has provided a kind of an innovative force in this present recent history and that there is a concern that that would be eliminated simply as the third market presently exists. I think one never can be totally sure what the elimination of a competitive alternative means as practical consequence.

We go on the assumption that normally we like competition. We aren't quite sure what the result is going to bring, and that's one of the good things about it. I think for that reason we have a concern with respect to its elimination as well.

Senator WILLIAMS. As I understand your position here, if there is to be legislation dealing with this possibility, you would have the Department of Justice in a position of overriding SEC determinations and even vetoing them?

Mr. KAUPER. No, Mr. Chairman. Our statement did not address that amendment offered by Senator Hart. I think my own feeling on that particular amendment, much as I suppose that a bureaucrat likes to think that he should have that authority, is somewhat to agree with Chairman Garrett, that it would be a little unseemly for the Attorney General to have the authority simply to override an independent regulatory agency. I would contemplate that it is certainly entirely possible that we would participate in the proceeding to present views to the Commission, but I think simply as a question of the separation of the relationship between the executive branch and the independent agency I would find it very hard to justify a veto.

Senator WILLIAMS. I don't think I have any more questions.

Senator BIDEN. I have one more question, Mr. Chairman.

What judicial remedy, if any, would be available to the Exchange if it was determined after all of the things that are set out that the third market should not be eliminated, or conversely, what are the options available to the third market if it is determined that it should be?

Mr. KAUPER. Let me take the first of your hypothetical problems first, which would be that a judgment is made by the agency that there is no basis for proceeding under this bill.

Now, I would assume that normally speaking there probably is not much by the way of judicial remedy available on that determination. Particularly now, I suspect that Chairman Garrett, in his testimony, might have been worrying about that when he talked about the question of whether the word "shall" shall be in there; whether there is any way the court can somehow compel the SEC to take action. I'm not sure of the answer to that, but I think if it is a discretionary matter it would be rather difficult to secure review.

On the other hand, if the decision were made to take the steps described here, I would suppose that the Commission's order would be reviewable just as any other order. I suppose—correct me if I am wrong—but I suppose it would be under the judicial review proceedings of S. 2519 if it were enacted.

Senator BIDEN. S. 2519, meaning the main bill?

Mr. KAUPER. That would be the review procedure in the court of appeals.

Senator BIDEN. Okay. Thank you very much.

Senator WILLIAMS. Thank you, Mr. Kauper.

Mr. Jones.

STATEMENT OF T. LAWRENCE JONES, PRESIDENT, AMERICAN INSURANCE ASSOCIATION, ACCOMPANIED BY WALTER D. VINYARD, JR., COUNSEL

Mr. JONES. Senator, we have some summaries. We couldn't get all of the material, but I think we have the relevant portions for your discussions here today.

Senator WILLIAMS. This is all statistical, isn't it?

Do you have any objection to the request of the subcommittee made more than 2 weeks ago?

Mr. JONES. No, sir. We have sent it to our companies, and we have asked them to furnish us with the information. They said it would take them some time to do it.

Senator WILLIAMS. Do you know how long that is going to take?

Mr. VINYARD. Senator Willams, if I could respond to that; we have gotten some data over the telephone in the past 2 or 3 days. I believe it will take several more weeks for our members throughout the country to give us this data.

Senator WILLIAMS. Aren't your viewpoints on this legislation drawn from experience, and isn't experience the basis for this information? Am I right or wrong?

Mr. VINYARD. To a certain extent. We can give you an estimation of the degree to which our members trade in the third market as to share volume for each year. It takes a long time to go back through records and compile that particular information.

Dollar volume is somewhat easier to do, and in the opinion of some of our executives is more meaningful. That's where the problem is. Percentages are easier to estimate.

Mr. JONES. In the last 3 years it's been—the percentage has been 9 to 10 percent of the dollar volumes of our trade that have been on the third market.

Quiet frankly, in 1974, in fact in the last 6 months, it's been much lighter than that, almost half that much, and that goes out of a concern of our member companies to put as many trades through the member brokers as they can. They are aware that the volume is low on the major exchanges.

Mr. VINYARD. I will be glad to read that into the record, the data that we have available at this time.

Senator WILLIAMS. What was that last statement? I thought you were going to say just the opposite.

You say the volume on the exchanges is lower?

Mr. JONES. Yes, our part of the trading has been lower during 1973 and also in 1974.

Senator WILLIAMS. You are increasing your trading, and you have——

Mr. JONES. No, we're increasing our trading on the exchanges. The proportion——

Senator WILLIAMS. That's not the way that came out.

I must have heard you wrong. Now, let's just state it absolutely. Your trading on the exchange is increasing.

Mr. JONES. Yes.

Sir, I'd like to just file our statement in full; and, if I may, I'll only read portions of it, and I will identify when we omit some of the material.

Senator WILLIAMS. All right (see p. 58).

Mr. JONES. My name is T. Lawrence Jones, and I am president of the American Insurance Association. I am here today to present the views of our members on S. 3126, and on two suggestions by Senator Tower.

In his floor statement, Senator Williams explained the bill is designed to give the Securities and Exchange Commission (SEC) adequate powers to deal with any crisis that may result from continued trading in the third market after fixed commission rates have been eliminated, while assuring no anticompetitive impact on present third market firms. As investors, our principal concern is that S. 3126 contain adequate safeguards so that no action taken under the bill could lessen the capability of dealers now operating off the floor of a stock exchange to make markets in listed securities.

The continued ability of third market dealers to handle institutional orders with the same degree of efficiency and flexibility which they now possess is important to the members of our association.

Third market firms are one of the few sources of competition with the specialist system on the New York Stock Exchange (NYSE) for making markets in common stock. Together with member firms which position blocks of stock, third market dealers enable institutions to trade in a manner least likely to disrupt the marketplace.

As financial institutions have grown, and as members have increasingly chosen to invest through professional managers, the specialist system for making orderly markets in common stock has not changed; and, if I may add a comment, Senator, I think that's a terribly important point. The specialist system was established to handle many small trades. They have not adjusted to the institutional trading, and it's a very serious problem with us; and that is the reason that the third market dealer is so imporant and the reason that we need that system.

Large dealer firms have developed the practice of negotiating trades off the exchange floor to meet this need. If the dealer regularly quotes a two-sided market in a security, he is called a market maker. Dealers which are members of the New York Stock Exchange, and which negotiate trades "upstairs," or off the exchange floor, are required by exchange procedures to take a completed trade to the floor in order to "cross" it for execution with the specialist which holds a monopoly to make markets for particular stocks on the floor.

If the dealer not only negotiates the transactions off the floor, but also executes it without participation of an exchange specialist, he is said to operate in a "third market" for listed stocks.

Although the member dealer and the third market dealer operate in the same way, and compete for some of the same business, when the member dealer executes on the exchange floor, procedures require the exchange community to collect two commissions from customers on the transaction—one from the buyer, and one from the seller. If

the dealer finds both sides of the transaction, it gets two commissions. If not, another firm receives the second commission. In addition to those commissions, the specialist may earn three separate fees when participating in the transaction. If the specialist supplies part of the passive side of a transaction in his capacity as a dealer, he receives a dealer's commission to the extent of his participation. The specialist may also receive two types of floor brokerage apart from the dealer's fee. The first is paid if any limit orders on his book participate in the block transaction. The SEC's Institutional Investor Study found that limit orders usually receive the benefit of any block discount or premium. In some situations, the Study said they do not. The Study also observed that stop orders received disadvantageous executions at times. The second type of floor brokerage is paid to the specialist in a block transaction by a dealer even though the dealer is represented at the post on the floor. In some cases, the Study reported such writeouts were earned by the specialist in return for his role as a finder in the block transaction. In specific instances, however, the Study concluded these "writeouts" raise regulatory questions, "particularly with respect to the independence of at least some specialists' administration of the retail market."

I have outlined the commissions and floor brokerage required by exchange rules at some length because the fact they apply to member dealers and not to third market dealers is the basic distinction, and, perhaps the only qualitative distinction between the two types of firms, both of which are so important to institutional investors. When we hear some spokesmen in the securities industry call for restrictions upon third market dealers, what we suspect they are really saying is that all dealers should be subject to the exchange's requirements on fixed dealer commissions and floor brokerage fees.

Now, Senator Biden, I think that is the chaos that they refer to: that there are not fixed dealer commissions and floor brokerage fees on third market transactions.

The suggestion that all trading in listed stocks should be required to take place on an exchange is usually based on the fear that including third market dealers in a composite quotation system will eliminate the auction market on at least one side of each trade. There is serious question, however, of the extent to which trades are presently "auctioned" on the exchanges themselves. This subcommittee's study found the percentage of trading on the New York Stock Exchange where a member firm acted as dealer on one side of the trade increased from 28.8 percent in 1945 to 45.1 percent in 1971. Inclusion of third market dealers with member firm dealers would not significantly affect this degree of dealer participation at present. Trading in the third market now equals approximately 7 percent of the total NYSE volume.

The fears of the exchange community, therefore, seem to be based more on statements by some of the largest, nationwide brokerage firms that at some future time they might consider doing most of their trading off the exchange floor. Certain recent articles in the financial press have stated Merrill Lynch has the capability to cross orders in house. It would seem appropriate for the subcommittee to invite these brokerage firms to testify on why they might consider leaving the exchange floor.

The greatest incentive for exchange membership would always seem to be the ability of member firms to achieve the best execution of customers' orders on the exchange floor. The greatest disincentive would appear to be a system of fixed floor brokerage and anticompetitive rules which seem to impede growth of a strong market-making capacity on the floor.

As the subcommittee has previously stated, "the question . . . is not whether the public is better served by an auction or a dealer market, but what features of those two markets should be preserved in the developing central market system."

We believe the correct balance between auction and dealer markets has been found in S. 2519, the National Securities Market System Act. Last November, I appeared before this subcommittee to testify in strong support of S. 2519. Our companies were encouraged when the committee reported that bill to the Senate floor in the form in which it emerged from this subcommittee. S. 2519 is one of the few bills we have addressed without suggesting improvements. We hope the bill's sponsors will be able to carry S. 2519 forward, and its momentum will not become disrupted by these hearings on S. 3126.

Now, if I can skip over to page 7, the last paragraph on that page.

In light of the broad authority over third market and member firm dealers which S. 2519 grants to the SEC it is questionable whether additional power is needed for the SEC to deal with any possible problems which could arise from third market trading after fixed rates are eliminated. Any conceivable ambiguity could be resolved by appropriate language in the committee's report on S. 2519, rather than proceeding with a new bill, or a floor amendment to S. 2519.

The decision whether to take an order to a member firm dealer or to a third market dealer is necessarily a subjective one. Each trade has certain variables, and the dealer likely to offer best execution in a particular situation will receive the order.

Third market firms during the past 4 years have annually received approximately 10 percent of the total common stock transactions from our members. Approximately the same amount has been executed through affiliated brokers on regional exchanges. Our members use on the average 10 different third market firms.

The traders in our companies say third market firms are quite competitive with member firms in executing institutional orders which do not require a dealer to take a very large position in the stock. Larger transactions may require the capital which a few member firms are capable of committing.

During 1973 there has been a noticeable decline in trading by our companies in all markets due to the general economic conditions. Third market firms appear to have felt this as much, if not more, than member firms. One of our companies, for example, reports its percentage of trades in the third market has declined from 9.2 percent in 1970 to 4.7 percent in 1973. Trading through affiliated broker-dealers appears to have decreased along the same lines.

Some of our members quite definitely are using all of their commission dollars in this difficult period to compensate brokerage firms which offer both good research and adequate execution. Based on our conversations in recent weeks with our investment officers, I would say the brokerage firm most likely to receive orders from our companies

today is the one which is capable in both research and execution. Since there is less trading, commissions during 1973 seem to have gone to firms with more than one area of expertise. Other services such as good handling of bonds and new issues are also important. The exchange community, therefore, should not think insurers are unmindful of their well being. Our portfolio managers have consciously directed more commission dollars towards member firms during a difficult year.

Our concern for capable member firms, of course, does not lessen our belief that competition between market makers would result in stronger securities markets, and more vigorous investor interest. In our opinion, attacks by member firms against nonmember firms does little to encourage investors to participate in the marketplace.

While third market firms account for a relatively small percentage of our companies' trading in listed stocks, they are more important than their market share would indicate because they introduce more competition into the execution and clearance of institutional orders. Our companies have found they cannot always depend on block positioners to handle a transaction, and specialists frequently do not have the capital to risk in a large trade. The third market, therefore, is a useful and often an essential market maker for listed securities. Any efforts to conform its trading procedures to those on exchanges would weaken the market for institutional transactions, and by doing so would result in less liquid and orderly markets for all investors.

While we believe the authority in S. 2519, is more than adequate for the SEC to deal with any situation which might arise after the implementation of fully competitive commission rates, we would have no objection to S. 3126 if it were amended to provide safeguards so that any action taken under its authority would not lessen the ability of third market dealers to trade listed stocks. We have every confidence in the present membership of the SEC, but we remember actions or nonactions by past Commissions which did not promote competition in this area. Examples are rule 19b–2, the exclusion of listed stocks from NASDAQ, and the addition of subsection (b) to NYSE Rule 394.

We support Senator Tower's suggestions, while we wish they went further, they are a sound step in the right direction. Senator Hart of the Subcommittee on Antitrust and Monopoly has also published an amendment to S. 2519 in the Congressional Record of March 19 to elicit comments during these hearings. Senator Hart's amendment provides the type of safeguards which we feel are necessary if the SEC is to receive the authority provided by S. 3126. We respectfully request the members of this subcommittee to give the Hart suggestions serious consideration.

Now, if I could skip in the statement, Senator, over to page 13, with the last paragraph beginning on page 13.

If the exchanges want third market dealers to become members, the way to attract them is to end fixed floor brokerage rates and anticompetitive rules which prevent competitive market makers from operating on the floor. In the past, the problem has not been so much the specific language in the rules as the way they have been administered. The history of NYSE Rule 394 is an example. Rule 394 requires member firms to obtain permission of the exchange before effecting a transaction in a listed stock off the exchange either as principal or agent. Member firms are thereby prevented from dealing with third market

firms. A SEC study of the rule in 1964 questioned its compatibility with the 1934 act, and its validity under the antitrust statutes. As a result, subsection (b) was added to rule 394 so that members could deal with third market firms under certain conditions. The conditions are rather lengthy, and have been satisfied only twice since adoption.

The New York Times carried an article February 2, 1973, on the circumstances surrounding one of the two occasions when a trade was executed in the third market by a member firm. Although the procedures required in rule 394 were satisfied, and approval granted by a floor governor, the chairman of the exchange is alleged to have ordered that he must personally approve any future off-board trades.

Because of this background, we believe subsection (e) (1) (A) would be more effective if it covered rules and practices of any national securities exchange. It would also be helpful if the report on his subsection focused specifically on NYSE Rules 394 and 113.

Rules 113 and 394 appear to discourage competition among exchange members. Rule 113, which prevents a specialist from dealing directly with an institution, preserves customers' orders for other exchange members. In return, the other members agree through rule 394 not to compete with the specialist as market makers. Rule 113 also represents an accommodation between "upstairs" block positioners and specialists.

The original intent of rule 113 was to lessen the possibility of market manipulation by specialists. Although the rule may well serve a valid regulatory purpose today, it would have little justification in the marketplace which should evolve if S. 2519 becomes law.

One large factor in the willingness of third-market firms to risk capital and position stock—one of the major factors—is their knowledge institutions will continue to deal with them on a regular basis. Specialists are probably reluctant to assume a similar role because they cannot contact the institutional market. If exchanges would allow competing marketmakers on their floor, there might be no regulatory need for rule 113. We believe this is a matter which requires careful examination by all concerned parties. The subcommittee may wish to elicit further testimony on this point before reporting S. 3126.

I very much appreciate the opportunity to appear today before this distinguished subcommittee. Your study of the securities industry, and the three major bills resulting from it, have attracted much favorable comment among our membership. We are confident as a result of these hearings that you will come forward with a reasonable and objective approach toward third-market trading. I shall be glad to answer any questions you may have, Senator Biden.

Senator BIDEN. The chairman had to leave, so if you don't mind, I would like to ask a few questions.

First of all, thank you for your confidence. It is often that everyone has that much confidence in us.

My primary question is: do you think that the elimination of fixed rates will lead to an increase in the amount of business your members do in the third market?

Mr. JONES. The decision to take a trade to the third market is, as we said, a subjective one; and it depends what kind of trade you have.

Our experience has been that a trade, say, of 3,000 shares of a stock worth about $50, you would be more than likely to take to a third market.

Maybe if you had 10,000 shares of a stock worth around $50 a share, you would be more likely to go to one of those member dealers who cross shares like Solomon Bros., where a lot of capital is required for the dealer to be able to cross the transaction.

It is generally felt that competitively determined or economically determined rates would increase the amount of trading on the exchanges.

There are other factors that have to be weighed. The specialist system is just not adjusting to meet the needs of the institutional investors. That's the reason we have developed these alternatives.

If we could have Mr. Vinyard add a comment to that, Senator Biden, I would appreciate it.

Mr. VINYARD. Senator Biden, I know that there may be a great deal of testimony to the effect that the third market attracts business because it's cheaper, because they are not under the fixed rate system.

Conversations with executives in our companies who determine these matters indicate that is not a major factor. The major factor is where the best marketmaker is for the particular trade.

For an order of 1,000 shares or less of a $50 stock listed on the New York Stock Exchange, the trade is likely to be taken to a regional exchange if the insurance company has an affiliated broker on that exchange, because there is a capacity on the floor of that exchange to handle that size order.

When you get into larger orders, including an order from 1,000 shares to 10,000 shares of a $50 New York Stock Exchange security, then our companies tell us it's a very competitive situation as to whether the order will go to a third-market firm or to a New York Stock Exchange member firm, depending on who offers the best execution at that particular time.

Senator BIDEN. You mean within the best execution for the larger transactions?

Mr. VINYARD. No, sir. I mean the ability to position the stock. If he has to risk some of his own capital, that's the major factor.

Senator BIDEN. So is it fair to say then that the elimination of fixed rates will have a negligible effect on the way your members trade listed securities?

Mr. VINYARD. Well, it certainly will stop the practice of taking trades to regional exchanges to avoid the fixed rates on the New York Stock Exchange.

Senator BIDEN. You just got finished telling me that you really don't do that.

Mr. VINYARD. For orders under 1,000 shares.

Senator BIDEN. How about orders under 1,000 shares?

Mr. JONES. We will go to the New York Stock Exchange more often on trades less than a thousand.

Senator BIDEN. On trades less than a thousand, your members would most likely go to the New York Stock Exchange more often with the elimination of fixed rates?

Mr. VINYARD. Senator Biden, there is one other category that I didn't discuss with you.

Senator BIDEN. Let us discuss it.

Mr. VINYARD. If you get into unusual transactions of over 10,000 shares of a $50 stock, in that situation it would probably be taken to

a New York Stock Exchange member firm, a large dealer that can commit substantial capital at risk, Solomon Bros. or Goldman Sachs. I just wanted to make that clear.

Senator BIDEN. But the reason for going there again to get back to my original question, really has nothing to do with the rates. It has to do with the ability to commit capital.

Mr. VINYARD. Principally.

Mr. JONES. The specialists with the limited capital they have on the New York Stock Exchange are not prepared to handle large institutional trades. You are maybe aware that before rule 19B2 that a number of our member companies had become members through affiliated brokers of the PBW Stock Exchange.

Senator BIDEN. I am delighted to see that as far as your members are concerned it is not of consequence whether or not trades are for more or less than a thousand shares.

Mr. JONES. Well, when we went to the PBW Stock Exchange, we started making trades there because about 41 institutions had gone down and made trades in those denominations, so there were enough traders. We were studying the specialist system there, and considering financing it so that they would have adequate capital to handle these size transactions, but rule 19B2 discouraged our people from exploring that.

Senator BIDEN. I understand that.

Mr. JONES. If I could go to one of your questions, we would say that S. 3126 is not necessary. We think there are adequate powers in S. 2519. We thought all of these problems were solved when this committee unanimously reported S. 2519. Our other comments about how to change S. 3126 are because the invitation asked us to address ourselves to that.

Senator BIDEN. I understand that. One last thing. If the elimination of fixed rates does anything at all in determining where your members go, it's likely in your opinion to move them to the floor of the stock exchange rather than away from the floor.

Mr. JONES. Yes, sir.

Senator BIDEN. I have been informed by the staff that the chairman, Senator Williams, would like to know a date by which you anticipate having the information requested?

Mr. JONES. Two weeks from today.

Senator BIDEN. Thank you very much. The hearing is adjourned until tomorrow at 2.

[Whereupon, at 5:05 p.m. the hearing was adjourned, to reconvene at 2 p.m. on Thursday, March 28, 1974.]

[Mr. Jones' complete statement, and a letter received from Mr. Vinyard, follow:]

STATEMENT OF T. LAWRENCE JONES, PRESIDENT, AMERICAN INSURANCE ASSOCIATION

My name is T. Lawrence Jones, and I am President of the American Insurance Association. I am here today to present the views of our members on S. 3126, and on two suggestions by Senator Tower.

In his floor statement, Senator Williams explained the bill is designed to give the Securities & Exchange Commission (SEC) adequate powers to deal with any crisis that may result from continued trading in the third market after fixed commission rates have been eliminated, while assuring no anticompetitive impact on present third market firms. As investors, our principal concern is

that S. 3126 contain adequate safeguards so that no action taken under the bill could lessen the capability of dealers now operating off the floor of a stock exchange to make markets in listed securities.

The continued ability of third market dealers to handle institutional orders with the same degree of efficiency and flexibility which they now possess is important to the members of our Association.

Third market firms are one of the few sources of competition with the specialist system on the New York Stock Exchange (NYSE) for making markets in common stock. Together with member firms which position blocks of stock, third market dealers enable institutions to trade in a manner least likely to disrupt the marketplace.

As financial institutions have grown, and as individuals have increasingly chosen to invest through professional managers, the specialist system for making orderly markets in common stock has not changed. Large dealer firms have developed the practice of negotiating trades off the exchange floor to meet this need. If the dealer regularly quotes a two-sided market in a security, he is called a market maker. Dealers which are members of the New York Stock Exchange, and which negotiate trades "upstairs," or off the exchange floor, are required by exchange procedures to take a completed trade to the floor in order to "cross" it for execution with the specialist which holds a monopoly to make markets for particular stocks on the floor.

If the dealer not only negotiates the transaction off the floor, but also executes it without participation of an exchange specialist, he is said to operate on a "third market" for listed stocks.

Although the member dealer and the third market dealer operate in the same way, and compete for some of the same business, when the member dealer executes on the exchange floor, procedures require the exchange community to collect two commissions from customers on the transaction—one from the buyer, and one from the seller. If the dealer finds both sides of the transaction, it gets two commissions. If not, another firm receives the second commission. In addition to those commissions, the specialist may earn three separate fees when participating in the transaction. If the specialist supplies part of the passive side of a transaction in his capability as a dealer, he receives a dealer's commission to the extent of his participation.

The specialist may also receive two types of floor brokerage apart from the dealer's fee. The first is paid if any limit orders on his book participate in the block transaction. The SEC's *Institutional Investor Study* found that limit orders usually receive the benefit of any block discount or premium. In some situations, the *Study* said they do not. The *Study* also observed that stop orders received disadvantageous executions at times. The second type of floor brokerage is paid to the specialist in a block transaction by a dealer even though the dealer is represented at the post on the floor. In some cases, the *Study* reported such "writeouts" were earned by the specialist in return for his role as a "finder" in the block transaction. In specific instances, however, the *Study* concluded these "writeouts" raise regulatory questions, "particularly with respect to the independence of at least some specialists' administration of the retail market."

I have outlined the commissions and floor brokerage required by exchange rules at some length because the fact they apply to member dealers and not to third market dealers is the basic distinction, and, perhaps the only qualitative distinction between these two types of firms, both of which are so important to institutional investors. When we hear some spokesmen in the securities industry call for restrictions upon third market dealers, what we suspect they are really saying is that all dealers should be subject to the Exchange's requirements on fixed dealer commissions and floor brokerage fees.

The suggestion that all trading in listed stocks should be required to take place on an exchange is usually based on the fear that including third market dealers in a composite quotation system will eliminate the auction market on at least one side of each trade. There eliminate the auction market on at least one side of each trade. There is serious question, however, of the extent to which trades are presently "auctioned" on the exchanges themselves. This Subcommittee's study found the percentage of trading on the New York Stock Exchange where a firm acted as dealer on one side of the trade increased from 28.8% in 1945 to 45.1% in 1971. Inclusion of third market dealers with member firm dealers would not significantly affect this degree of dealer participation at present. Trading in the third market now equals approximately seven percent of the total NYSE volume.

The fears of the exchange community, therefore, seem to be based more on statements by some of the largest, nationwide brokerage firms that at some future time they might consider doing most of their trading off the exchange floor. Several recent articles in the financial press have stated Merrill Lynch has the capability to cross orders in house. It would seem appropriate for the Subcommittee to invite these brokerage firms to testify on why they might consider leaving the exchange floor.

The greatest incentive for exchange membership would always seem to be the ability of member firms to achieve the best execution of customers' orders on the exchange floor. The greatest disincentive would appear to be a system of fixed floor brokerage and anticompetitive rules which seem to impede growth of a strong market-making capacity on the floor.

As the Subcommittee has previously stated, "the question . . . is not whether the public is better served by an "auction" or a "dealer" market, but what features of those two markets should be preserved in the developing central market system."

We believe the correct balance between "auction" and "dealer" markets has been found in S. 2519, the "National Securities Market System Act." Last November, I appeared before this Subcommittee to testify in strong support of S. 2519. Our companies were encouraged when the Committee reported that bill to the Senate floor in the form in which it emerged from this Subcommittee. S. 2519 is one of the few bills we have addressed without suggesting improvements. We hope the bill's sponsors will be able to carry S. 2519 forward, and its momentum will not become disrupted by these hearings on S. 3126.

S. 2519 provides the SEC with authority to facilitate development of markets where buying and selling interests will be centralized, and undue price movements avoided. Transactions in the third market would be integrated with exchange transactions through a composite tape. Section 11 of S. 2519 would amend Section 15(c) of the Securities Exchange Act of 1934 (the Act) to extend the SEC's authority over third market dealers. S. 470, which we supported, and which passed the Senate on June 18, 1973, provides the SEC with authority to require all broker-dealers trading for their own account to yield priority, parity and precedence to all public orders. S. 2519 would further amend Sections 11(b) and 15(c)(6) of the Act to authorize the SEC by rule to require or permit disclosure of any limited price order placed with any dealer, whether an exchange member or a third market firm. S. 2519 recognizes a strong national market system will not be possible unless vigorous competition is encouraged between all market makers. The SEC, moreover, would have specific authority under the bill to require third market dealers to make tight and continuous markets (Section 15(c)(6) as amended by Section 11 of S. 2519). The purpose of integrating all market makers into a single system is not to make them all do business in the same way, but rather to enable investors to take fuller advantage of the distinctive contributions each group makes. With this in mind, Section 7 of S. 2519 directs the SEC in new Section 11A(k) of the Act to take steps to assure that all market makers, both on the exchange and in the third market, are subject to equal regulations to the extent that such persons are similarly situated in terms of the purposes of such regulations.

In light of the broad authority over third market and member firm dealers which S. 2519 grants to the SEC it is questionable whether additional power is needed for the SEC to deal with any possible problems which could arise from third market trading after fixed rates are eliminated. Any conceivable ambiguity could be resolved by appropriate language in the Committee's report on S. 2519, rather than proceeding with a new bill, or a floor amendment to S. 2519.

The decision whether to take an order to a member firm dealer or to a third market dealer is necessarily a subjective one. Each trade has certain variables, and the dealer likely to offer best execution in a particular situation will receive the order.

Third market firms during the past four years have annually received approximately ten percent of the total common stock transactions from our members. Approximately the same amount has been executed through affiliated brokers on regional exchanges. Our members use on the average ten different third market firms.

The traders in our companies say third market firms are quite competitive with member firms in executing institutional orders which do not require a dealer to take a very large position in the stock. Larger transactions may require the capital which a few member firms are capable of committing.

During 1973 there has been a noticeable decline in trading by our companies in all markets due to the general economic conditions. Third market firms appear to have felt this as much, if not more, than member firms. One of our companies, for example, reports its percentage of trades in the third market has declined from 9.2% in 1970 to 4.7% in 1973. Trading through affiliated broker dealers appears to have decreased along the same lines.

Some of our members quite definitely are using all of their commission dollars in this difficult period to compensate brokerage firms which offer both good research and adequate execution. Based on our conversations in recent weeks with our investment officers, I would say the brokerage firm most likely to receive orders from our companies today is the one which is capable in both research and execution. Since there is less trading, commissions during 1973 seem to have gone to firms with more than area of expertise. Other services such as good handling of bonds and new issues are also important. The exchange community, therefore, should not think insurers are unmindful of their well being. Our portfolio managers have consciously directed more commission dollars toward member firms during a difficult year.

Our concern for capable member firms, of course, does not lessen our belief that competition between market makers would result in stronger securities markets, and more vigorous investor interest. In our opinion, attacks by member firms against non-member firms does little to encourage investors to participate in the marketplace.

While third market firms account for a relatively small percentage of our companies' trading in listed stocks, they are more important than their market share would indicate because they introduce more competition into the execution and clearance of institutional orders. Our companies have found they cannot always depend on block positioners to handle a transaction, and specialists frequently do not have the capital to risk in a large trade. The third market, therefore, is a useful and often an essential market maker for listed securities. Any efforts to conform its trading procedures to those on exchanges would weaken the market for institutional transactions, and by doing so, would result in less liquid and orderly markets for all investors.

While we believe the authority in S. 2519 is more than adequate for the SEC to deal with any situation which might arise after the implementation of fully competitive commission rates, we would have no objection to S. 3216 if it were amended to provide safeguards so that any action taken under its authority would not lessen the ability of third market dealers to trade listed stocks. We have every confidence in the present membership of the SEC, but we remember actions or non-actions by past Commissions which did not promote competition in this area. Examples are Rule 19b–2, the exclusion of listed stock from NASDAQ, and the addition of subsection (b) to NYSE Rule 394.

We support Senator Tower's suggestions. While we wish they went further, they are a sound step in the right direction. Senator Hart of the Subcommittee on Antitrust & Monopoly has also published an amendment to S. 2519 in the *Congressional Record* of March 19 to elicit comments during these hearings. Senator Hart's amendment provides the type of safeguards which we feel are necessary if the SEC is to receive the authority provided by S. 3126. We respectfully request the members of this Subcommittee to give the Hart suggestions serious consideration.

If the intent in S. 3126 is to provide the SEC with "fail-safe" power, then the authority in the bill should be discretionary rather than mandatory. The Commission should not be required to institute a formal proceeding to deal with a crisis which, in the opinion of many disinterested observers, is not likely to occur. The Commission's staff is limited. A study of third market trading in all likelihood would slow progress towards development of a composite transaction and quotation system, which is essential for a stronger market in common stock. We propose, therefore, that the word "shall" in line six on page one of S. 3126 should be changed to "may."

Since the result of a hearing pursuant to S. 3126 would be a requirement that third market dealers join a trade association formed by their competitors, and abide by its rules and regulations, we favor several changes in S. 3126 designed to minimize the potential anticompetitive effects of such a requirement.

In line two on page two of S. 3126, we would recommend the hearing specifically be on the record. Before the SEC could promulgate a rule under S. 3126 we believe a higher burden of proof should be met than presently provided. The standard "likely to be" in line 13 on page two should be altered to "substantially

certain to be." A clause similar to the one recommended by Senator Hart for insertion after the sentence ending on line 14 of page two would direct the SEC to "adopt the least competitive means of preserving fair and orderly markets." That would be a valuable addition. Similarly, the phrase "on such exchanges or the ability of such exchanges to carry out their responsibilities under this title" in lines 11 and 12 on page two should be deleted. The point of view from which the SEC should approach this inquiry is whether the fairness or orderliness of all markets for common stock is affected, rather than whether exchanges are affected by market makers operating off the exchange floor.

In the same light, paragraph (e)(2) of S. 3126 should be clarified so that exchange rules prescribing the sequence of dealer orders must be based upon the need to preserve priority for orders of public customers. This change in line 24 on page two might deter exchanges from discriminating against third market dealers if they were admitted to membership. The reference to Commission rules in line 2 of page three should also be clarified by specifying they are rules "relating to priority of orders for public customers."

The practices and consequences of third market trading are not new or unknown. The argument for requiring third market dealers to trade on exchanges rest on the assumption their trading will take on entirely different characteristics after the introduction of fully competitive commission rates. Any action taken by the SEC under S. 3126 should be based upon evidence gathered after fixed rates end, and after the effects of competition can be seen. As S. 3126 is presently drafted, it would be possible for the SEC to promulgate a rule requiring exchange trading of listed stocks on the day fully competitive rates become operative. We would prefer to see Section (e)(3) on page three revised so "the proceeding authorized pursuant to subsection (1) may not commence until the rules of national securities exchanges fixing rates of commission have been eliminated."

Subsection (e)(1)(A) of S. 3126 is an admirable attempt to institute competition between dealers which are specialists and dealers which are not. Although third market firms are not requesting exchange membership, some have said they would join and trade on exchanges after fixed rates end if that is where the business goes.

If the exchanges want third market dealers to become members, the way to attract them is to end fixed floor brokerage rates and anticompetitive rules which prevent competitive market makers from operating on the floor. In the past the problem has not been so much the specific language in the rules as the way they have been administered. The history of NYSE Rule 394 is an example. Rule 394 requires member firms to obtain permission of the exchange before effecting a transaction in a listed stock off the exchange either as principal or agent. Member firms are thereby prevented from dealing with third market firms.

A SEC study of the rule in 1965 questioned its compatibility with the 1934 Act, and its validity under the antitrust statutes. As a result, subsection (b) was added to Rule 394 so that members could deal with third market firms under certain conditions. The conditions are rather lengthy, and have been satisfied only twice since adoption.

The *New York Times* carried an article Feb. 2, 1973 on the circumstances surrounding one of the two occasions when a trade was executed in the third market by a member firm. Although the procedures required in Rule 394 were satisfied, and approval granted by a floor governor, the Chairman of the Exchange is alleged to have ordered that he must personally approve any future off-board trades.

Because of this background, we believe Subsection (e)(1)(A) would be more effective if it covered rules and *practices* of any national securities exchange. It would also be helpful if the report on this subsection focused specifically on NYSE Rules 394 and 113.

Rules 113 and 394 appear to discourage competition among exchange members. Rule 113, which prevents a specialist from dealing directly with an institution, preserves customers' orders for other exchange members. In return, the other members agree through Rule 394 not to compete with the specialist as market makers. Rule 113 also represents an accommodation between "upstairs" block positioners and specialists.

The original intent of Rule 113 was to lessen the possibility of market manipulation by specialists. Although the rule may well serve a valid regulatory purpose today, it would have little justification in the marketplace which should evolve if S. 2519 becomes law.

One large factor in the willingness of third market firms to risk capital and position stock is their knowledge institutions will continue to deal with them on

a regular basis. Specialists are probably reluctant to assume a similar role because they cannot contact the institutional market. If exchanges would allow competing market makers on their floor, there might be no regulatory need for Rule 113. We believe this is a matter which requires careful examination by all concerned parties. The Subcommittee may wish to elicit further testimony on this point before reporting S. 3216.

I very much appreciate the opportunity to appear today before this distinguished Subcommittee. Your study of the securities industry, and the three major bills resulting from it have attracted much favorable comment among our membership. We are confident as a result of these hearings that you will come forward with a reasonable and objective approach towards third market trading. I shall be glad to answer any questions you may have.

AMERICAN INSURANCE ASSOCIATION,
Washington, D.C., April 9, 1974.

Hon. HARRISON A. WILLIAMS,
Chairman, Securities Subcommittee, Committee on Banking, Housing and Urban Affairs, Dirksen Office Building, U.S. Senate, Washington, D.C.

DEAR SENATOR WILLIAMS: We are pleased to respond to your March 7 request for seven categories of information concerning the share and dollar volume of trading in listed securities by our member companies in various markets for the years 1970 through 1973.

Your letter has been distributed to our membership throughout the country. Some of our companies, particularly smaller insurers, have told us all of the information would be quite difficult to compile. One member, headquartered in New Jersey, has replied "the information requested by Senator Williams regarding our trading would involve a great deal of effort." Another insurer, domiciled in New York City, has responded that "it would take approximately 30 full working days for one person to sift out and quantify the information on the basis requested." Because of their regard for your work on S. 470 and S. 2519, however, several of our companies have prepared responses to your first question.

The chief difficulty is the request for share volume in question one. Most companies prefer to use dollar volume because they believe it is a more reliable statistic, i.e., it is not distorted by stock splits, etc. Enclosed are responses by two representative members of this Association to questions one and two. Company "A" is a prominent nationwide insurer headquartered in the Mid-Atlantic United States. Company "B" enjoys an equivalent reputation and is located in the upper Midwest. Company "A" is not affiliated with any broker-dealer, and, therefore, has not benefitted from the 40% non-member discount available through the New York Stock Exchange. Company "B" is affiliated with a broker-dealer admitted to membership on the PBW Stock Exchange, and the Pacific Coast Stock Exchange. Company "B", however, has not made use of the 40% discount available to its brokerage affiliate.

In our opinion, the data from these two companies is an accurate representation of the trading done by members of this Association. The information received in response to your first and second questions reveals some interesting facts. Although Company "B" is affiliated with a broker on the PBW Stock Exchange, and Company "A" is not, Company "A" does considerably more of its trading on the PBW than does Company "B". Furthermore, Company "B" did a significantly higher percentage of its trades through third market firms from 1970 through 1972, even though it was affiliated with a broker on both the Pacific Coast and PBW Exchanges.

Other information we have obtained confirms the market best able to handle a trade at a particular time is the one which usually receives the order. This often produces rather inconclusive data when comparing one company to another. On the average, however, it appears our members directed ten percent of their trades to third market firms from 1970 through 1972.

A number of our members tell us trading in all markets declined significantly during 1973, and this trend is continuing through 1974. This does not seem to be true in all situations as shown on the attached chart responding to your first two questions. Some insurers, however, have slowed down their trading because of general uncertainty about the economic outlook. The companies in this category tell us the commission dollars which they do spend are directed towards New York Stock Exchange member firms which provide good research or other services such as capable handling of bonds and new issues. Firms such as third market dealers which provide only execution capability are usually the first to feel the results of lower institutional trading volume. Executions through affiliated broker-

dealers also appear on the average to have been curtailed substantially during 1973 and 1974.

Your third question asks for the size of the average trade in each market. On the New York Stock Exchange, this would probably be in the neighborhood of 2,000 shares or a dollar value of approximately $55,000. The same would be true on the AMEX. On the regional exchanges, however, the size of an average trade is approximately 9,000 shares with a dollar value of $330,000. The size of the average trade in the third market is more difficult to determine since orders vary from 1,000 or 2,000 shares up to over 10,000 shares. One company reports the average size of its third market trades from 1970 through 1973 is 5,000 shares or $125,000. Another company states the average dollar value of its third market trades ranged from $387,900 in 1970 to $147,200 in 1972. The lower figure in our opinion would be more typical.

In response to previous questions from your Subcommittee, we have stated the percentage of total trading in listed securities done by our member companies on national securities exchanges through affiliated brokers is approximately ten percent. This same answer would apply to question four. The highest percentage in a given year for any single company is approximately 21%.

Very few companies are now utilizing the 40% non-member discount allowed by the New York Stock Exchange under certain conditions. One company which is making use of it reports the percentage of total trading through affiliates which receive a 40% non-member discount is 3.9% of its total trading in 1973. This same company executed approximately 4.6% of its total business in 1973 through an affiliated broker-dealer, and approximately 4.7% through third market firms during the same year.

Our companies frequently do business with as many as ten third market firms, and on the average appear to use around four for most of their transactions. One company has used as many as 14 different third market dealers in a single year.

We hope this information is helpful to you. It is always a pleasure to assist the work of the Securities Subcommittee.

Sincerely yours,

WALTER D. VINYARD, Jr., *Counsel.*

Year, company, and volume	Markets					
	NYSE	AMEX	MIDW	PBW	PACIF	THIRD
1973:						
A:						
Shares	3,987,000	10,000	500,000	1,000,000	200,000	300,000
Dollars	99,675,000	375,000	12,500,000	25,000,000	5,000,000	7,500,000
Percent	66.4	.3	8.3	16.6	3.4	5
B:						
Shares	3,380,000	38,000	117,000	152,000	114,000	390,000
Dollars	135,300,000	1,520,000	4,560,000	6,080,000	4,560,000	15,600,000
Percent	73	1	3	4	3	6
1972:						
A:						
Shares	2,983,000	175,000	240,000	400,000	100,000	150,000
Dollars	74,575,000	4,375,000	6,000,000	10,000,000	2,500,000	3,750,000
Percent	73.7	4.3	5.9	9.9	2.5	3.7
B:						
Shares	3,420,000	38,900	116,700	77,800	233,400	1,197,000
Dollars	136,900,000	1,550,000	4,680,000	3,120,000	9,360,000	47,900,000
Percent	72	1	3	2	6	16
1971:						
A:						
Shares	1,249,000	90,000	80,000	200,000	40,000	60,000
Dollars	31,225,000	1,875,000	2,000,000	5,000,000	1,000,000	1,500,000
Percent	73.7	4.4	4.7	11.7	2.3	3.6
B:						
Shares	2,950,000	32,400	97,200	64,800	97,200	1,156,000
Dollars	118,100,000	1,300,000	3,900,000	2,600,000	3,900,000	46,200,000
Percent	73	1	3	2	3	18
1970:						
A:						
Shares	2,640,000	0	160,000	280,000	80,000	160,000
Dollars	66,000,000	0	4,000,000	7,000,000	2,000,000	4,000,000
Percent	79.5	0	4.8	8.4	2.4	4.9
B:						
Shares	2,480,000	26,300	52,600	26,300	52,600	625,000
Dollars	98,800,000	1,050,000	2,100,000	1,050,000	2,100,000	25,000,000
Percent	81	1	2	1	2	13

Notes: (1) Thejshare and dollar volume of trading in listed securities done by your member companies in each market for listed securities (e.g., NYSE, AMEX, MSE, PBW, PCSE and the third market). (2) The percentage of total trading in listed securities done by your member companies in each such market.

SEC AUTHORITY OVER THIRD MARKET TRADING

THURSDAY, MARCH 28, 1974

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 2 p.m. in room 5302 of the Dirksen Senate Office Building, Senator Harrison A. Williams, chairman of the subcommittee, presiding.

Present: Senators Williams, Biden, and Brock.

Senator BIDEN. In the absence of the chairman of the subcommittee I will call the hearing to order. The first witness is H. Virgil Sherrill. He appears on behalf of the Securities Industry Association.

Mr. Sherrill?

STATEMENT OF H. VIRGIL SHERRILL, MEMBER, EXECUTIVE COMMITTEE, BOARD OF DIRECTORS, AND GOVERNING COUNCIL, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY JAMES C. BRADFORD, JR., J. C. BRADFORD & CO., NASHVILLE, TENN., AND MEMBER, SECURITIES INDUSTRY ASSOCIATION'S BOARD AND GOVERNING COUNCIL; AND RICHARD O. SCRIBNER, VICE PRESIDENT AND GENERAL COUNSEL, SECURITIES INDUSTRY ASSOCIATION

Mr. SHERRILL. My name is H. Virgil Sherrill. I appear before this committee on behalf of the Securities Industry Association, of which I am a member of the executive committee, board of directors and governing council. I have recently been appointed chairman of the association's special committee on the Central Market System. Professionally I am president of Shields & Company, Inc., and have been engaged in the securities business for the past 25 years. Accompanying me today to assist in answering your questions are James C. Bradford, Jr., who is a partner in the firm of J. C. Bradford & Co., Nashville, Tenn., and a member of the association's board and governing council; and Richard O. Scribner, vice president and general counsel of the SLA.

The Securities Industry Association is a national trade association representing 745 organizations which serve investors from locations throughout the Nation. Its membership is a virtual cross-section of the securities business, encompassing members of the New York, American and regional stock exchanges and the NASD. By type of business these firms include retail and institutionally oriented brokers, over-the-counter dealers, underwriters, investment bankers, floor specialists and brokers as well as municipal and Government securities dealers. Collectively, these members account for approximately 95 percent of the securities business done in this country.

Last November the SIA testified before this subcommittee on S. 2519, the National Securities Market System Act of 1974. At that time we urged an addition to that legislation which would affirmatively require all brokers and dealers to effect all transactions in listed securities on the exchanges on which those securities are listed. We testified that this centralizing requirement is necessary to prevent the bypassing, and consequently the erosion, of the agency auction market. We expressed the strong belief that the auction market is best for individual investors and is an integral part of the mechanism that raises much needed capital for the American economy. We were frankly disappointed that this suggestion was not made a part of S. 2519.

It's not my purpose today to reiterate the special merits of the agency auction markets. These markets are in fact broadly acknowledged as the finest trading markets for securities to be found anywhere in the world. They form the basis for a system which over the past decades has raised annually billions of dollars of equity and debt capital for American business, and which facilitates the free and efficient allocation and redeployment of the financial wealth of this Nation among the myraid of enterprises and governmental uses that compete for it daily. Equally important, they provide the best protection for public individual investors. It is the agency auction markets with their continuous quotations, full publicity of transactions, rules demanding parity and precedence of public orders, and other public interest safeguards that have engendered a high degree of public confidence in the essential fairness of the Nation's securities market system. Although many of us who are in the securities business might in the short run find it less costly and less restrictive to transact business exclusively in the dealer over-the-counter market, we are convinced that the agency auction market is in the long run best interest of our public customers. Virtually every responsible commentator agrees that its fundamental attributes must be preserved and protected.

However, we cannot be certain that these markets will remain viable in the future just because they are the best markets. Even now there is disturbing evidence that the agency auction markets are being eroded. As institutions become increasingly dominant, liquidity in all but a few issues suffers, values appear to be distorted, and ownership concentrated in fewer hands, individual investors feel that institutions occupy a favored place, and many companies find themselves unable to afford or attract the capital they need.

Just as the securities markets are subject to great stress, so too are the Nation's economic circumstances undergoing rapid change and facing exceptional uncertainty. We are living in what some have termed "a shortage economy." The capital markets, much like the economy, have been jolted by the effects of the energy crisis, the shortages of basic raw materials, political instability abroad, the dramatic increase in the economic power of those who provide the world with oil and other scarce resources. In this time of change and instability in these external factors, it is especially vital to keep the capital markets mechanism of this country viable and functioning efficiently as it has in the past. To permit an erosion in that market's structure during this period could lead to serious damage to the entire economy of this Nation.

The securities industry itself does not yet know the consequences of fully competitive rates or what other major structural changes may

be incident to the transition to a national central market system. Indeed, the elusiveness of that very concept recently caused SIA's board of directors to appoint a special committee of which I am chairman to define the specifics of the central market system more clearly, to suggest which rules must be the same under the principle of equal regulation, to consider how such a system might be implemented, and how it's costs might be borne.

At the present time, nagging unprofitability has been added to these structural uncertainties, and many firms will face difficulties in obtaining new capital or renewing existing capital. In these circumstances it is only natural that firms will be forced by short-term considerations to transact business in a market which provies them the greatest potential profit. Without the incentive of the minimum commission rate, not only is it probable, if is very likely that firms will elect to leave the exchanges to trade net in the over-the-counter market. As this flight from the auction markets proceeds, trading will become more fragmented and the liquidity of the listed market will decline causing further defections. In the end public individual investors will suffer.

In our opinion, the provisions now embodied in S. 3126 represent the barest minimum of protection to the agency auction process during a period of great change and uncertainty in securities markets and the securities industry. This bill is intended solely to provide a "fail safe" for the interval from the end of all fixed minimum commission rates to the establishment of a national market system. It would direct the SEC to eliminate off-board trading if the Commission finds, among other things, that such activity is so disruptive of the auction markets that those markets have been, or are likely to be, unable to operate in the public interest. Certainly such a provision reduces the possibility of a permanent impairment of the auction markets. However, a certain degree of upset appears to be necessary even to warrant the Commission holding hearings, and given the procedures and findings required, it is very possible that the Commission would be unable to act as promptly as circumstances might require.

Nevertheless, giving the Commission limited authority is preferable to denying it the right to act at all. It is also desirable that the Commission be given this specific direction as to the remedy to be prescribed so that its authority will be clear and unquestionable. Therefore, in view of our deep concern for the preservation of deep, liquid agency auction securities markets which favor individual customers, we support S. 3126 without qualification.

Senator BIDEN. If I may interrupt here, I have got 5 minutes to make the vote. I apologize for the interruption.

[Recess.]

Senator BROCK. We can go ahead with the session. We have abused you because we have had a vote every 30 minutes. We will get as much of your testimony as we can for the record.

We will proceed. Go ahead, if you will.

Mr. SHERRILL. Thank you, Senator.

The policy position of the SIA speaks clearly of the need to fully incorporate existing third market activities into a national central market system for listed securities. We believe that means can be found to accomplish this. At the same time, we place primary emphasis on the need to preserve and indeed to improve the agency

auction process. It might be noted that for 1973, sales of NYSE listed stocks in the so-called third market only amounted to 5.8 percent of total shares sold on that exchange and 7 percent of dollar value of such sales. An even more pertinent perspective is provided by the fact that fewer than 30 securities firms are registered as "third market makers"—SIA alone consists of almost 600 broker-dealer members. Would it not be better to integrate that group of firms into the agency auction system than to risk the destruction of a mechanism which so well serves millions of individual investors and thousands of listed companies?

Summing up, then, we find that the virtues and values of the agency auction markets are widely known and accepted. It is also generally agreed that any material erosion of these markets would have serious repercussions for the American and perhaps the world economy. Nevertheless, we—the securities industry—are approaching a period for which the forecast is change, stress, and uncertainty. At the least, it is very possible that an end to the minimum commission rate system will cause existing members to abandon the exchanges in favor of the dealer market. Other ongoing alterations in the system may also weaken the auction market system. What is needed, at a minimum, is a bridge between the existing order and the implementation of a fully operational national central market system. S. 3126 provides that minimum requirement, and on that basis we urge that it be adopted promptly and without weakening amendments.

Thank you. My colleagues and I will be happy to respond to your questions.

Senator BROCK. Thank you, Mr. Sherrill.

I should point out that I am delighted you are accompanied by one of my distinguished constituents, Mr. Bradford.

Let me ask you to spell out a couple of particulars, any of you.

You mentioned the possibility of leaving the exchange.

Mr. SHERRILL. Yes, sir.

Senator BROCK. Under what conditions and why?

Mr. SHERRILL. I cannot speak for the SIA constituents on this matter because we have never really polled the membership.

As President of Shields and Company, I can state that my firm would consider leaving the exchange if the economic conditions of the industry indicated that we should.

To explain that perhaps a little more in detail, it costs us a considerable amount of money for the privilege of doing business on the New York Stock Exchange. Certainly, these charges would be eliminated if we did business in the dealer market. If we found the dealer market to be of such a nature that we could serve our customers and at the same time generate business on a more profitable basis, we would be very much inclined to leave the exchange.

Senator BROCK. You simply can't find the advantages to offset potential costs?

Mr. SHERRILL. I'm certain we would make a careful appraisal and weigh the pros and cons before making a move of that type.

If the dealer markets didn't develop to the extent we think they might, we might consider leaving the exchange.

Senator BROCK. The advantages primarily being what, to allow you to have an alternative commission structure or cost base or what other than your investment routine itself?

Mr. SHERRILL. The prime reason is predictable on a very essential fact. I don't want to sound mercenary in this regard, but we are in the business to make money. In the past several years, I think many firms in our industry haven't necessarily lived up to that standard.

That would be a very strong motivating factor why Shields and Company would leave the exchange.

This is all based on the assumption that we would be able to do the business for our customers, both individual investors and institutional investors, in a manner that would represent good execution and give them full service.

Mr. BRADFORD. Senator, if I may make two points. The question we are anticipating here is whether or not we are negotiating commissions. If we are doing that, large customers will be able to demand very low rates of commission or none at all. One way to avoid this happening is to get off the exchange and deal with the customers as principal, that is, sell directly to them or buy directly from them.

In this way, the customer does not know what our commission is. Therefore, he obviously cannot negotiate up or down.

Second, our firm last year spent $1,400,000 in dues and assessments and New York floor and cage costs in order to do business on the stock exchanges, the ones that we are members of.

Some of the things that we are paying for, we would have to pay for in the dealers market, but there is enough involved that we would certainly have to consider all alternatives.

Mr. SHERRILL. Senator, might I make one more remark in this regard, to answer your question?

As the two markets exist today, there is a great disparity that relates to the regulations that govern each of the two market places. Under the present rules, we would find it much easier to do business away from the floor of the New York Stock Exchange, in a looser regulatory atmosphere.

Senator BROCK. In that trend, we are accelerated to where if a great number of people did it, would the pressure grow on the Congress to accelerate the amount of regulation on those who are outside of the exchange?

Mr. SHERRILL. I would hope that the Securities and Exchange Commission would take those steps regardless of what happens in that direction. I pointed out prior to your entrance into the room that we fully support Senator Williams' introductory remarks yesterday as they related to equal regulation.

Senator BROCK. If you all did leave the exchange, Mr. Bradford, wouldn't that be of some considerable disadvantage to the small investor particularly?

Mr. BRADFORD. Yes. We feel it would definitely be to his disadvantage. Anything that weakens the auction market we feel hurts the small investor because the auction market is where if the Morgan Bank in New York sells 100,000 shares of General Motors to the Bank of America in California. Aunt Jenny in Chattanooga, Tenn., gets a chance to participate in that transaction and at the same prices those two institutions do.

They don't in a dealer market.

Senator BROCK. I'm a little confused. I think I saw in your statement somewhere the fact that 7 percent of the dollars and less than that of the shares are traded in the third market today.

Mr. SHERRILL. That is in the testimony.

Senator BROCK. Is it that much of an impact?

Mr. SHERRILL. It's not that much of an impact today, but what we are trying to say is if flight from the New York Stock Exchange or from a series of exchange floors continues or builds up as a result of conditions that may exist between the elimination of the negotiated commission rates and the implementation of the central market system, if during that period this business continues to build up, then it could become a very material factor in affecting adversely the liquidity of the auction market.

Senator BROCK. If you take this along exactly as it is and if the SEC made a finding that all listed securities had to be traded in the auction market—you said we are only talking about 7 percent, but you are talking about a ton of money. That is a very large amount of transactions and a large dollar value.

If you take them out of the third market, would you not enormously disable the third market?

Let us look at the options that exist for smaller companies whose stock is largely privately held who are not listed. They use the third market to good advantage, trade their securities, don't they?

Mr. SHERRILL. I think that is true, Senator. But I think what you are referring to, as you point out, are unlisted securities.

Mr. SHERRILL. My primary concern is about the public individual investor. If he is able to transact his business in a better market place, and that is the agency auction market, then I think that those firms that today are members of the third market can well join in this integrated system.

Senator BROCK. If you take unlisted securities out of the third market, do you not jeopardize the existence of it?

Senator BROCK. I grant all that. I have the same concern that you do. But, you can't exclude from the consideration of that concern people's whose stocks are not listed.

Mr. SHERRILL. The number of firms that today comprise the third market that deal in listed securities—and, that is what we are now focusing on—those firms number a total of 30 firms that are listed as third market firms. That is not a very large number.

The firms that deal in over-the-counter securities, unlisted, probably is up in the hundreds. I don't think it would effect the market if those so-called third market firms were forced to deal in listed securities on the exchange.

Mr. SCRIBNER. Senator, I think it is important that we keep in mind that we are not talking about the over-the-counter market as such, but a segment of the over-the-counter market that is dealing in listed securities.

It is what is called the third market.

Senator BROCK. The third market is a market that works for listed as well as unlisted securities.

Mr. SCRIBNER. It provides for trading in listed securities in the over-the-counter market, just those securities which are listed in the exchange which are traded over the counter.

Mr. SHERRILL. When we refer to the third market, we mean those firms dealing in listed securities in the over-the-counter market.

Senator BROCK. We have got a good deal of conversation and criticism of the stock exchange monopoly.

I wonder if you would like to comment on that.

Mr. BRADFORD. Senator, we do not think that the stock exchange is a real monopoly. The stock exchange is a place where 500 or 600 firms meet and compete like the dickens. There is no reason why the third market cannot show their orders on the stock exchange, too. It is no monopoly.

Senator BIDEN. I apologize again for having left in the middle of your statement. I understand that Senator Brock has pursued the question of why your members now feel it would be necessary to leave the exchange and go to the third market after the advent of negotiated roles.

Do I understand that your present position is that members would have to consider that move seriously, but could not be absolutely sure? Is that correct?

Mr. SHERRILL. That is correct.

Senator BIDEN. What would you have to consider?

Mr. SHERRILL. The economic impacts on the firm. Here, again, as I pointed out earlier. I am speaking not for the STA members. We have not polled our membership on this point.

I am speaking for Shields and Co.

Senator BIDEN. How would you determine that economic impact? Can you not determine it now or would you only be able to determine it in the future?

What would you be able to do when we go to competitive rates that you are not able to do now in making your determination of whether or not you stay or leave?

Mr. SHERRILL. One of the price considerations that my firm would probably face would be predicated on the quality again, of the third market, or the over-the-counter market for listed stocks.

Senator BIDEN. You know what that quality is now. How would it change?

Mr. SHERRILL. We know what it is now, but if it grows and if these rules are changed to the extent where the trading in unlisted securities begins to broaden out into those markets, we then would try it and, I suppose, be induced to that.

Our next consideration would be an economic consideration, where could our firm do business profitably. Today, I can't honestly tell you what the dollar and cents impact would be.

Senator BIDEN. I am less familiar with this field than maybe other members of this committee. Maybe that is why I'm asking such basic questions. But, I cannot yet fully comprehend your reasoning.

In predicting the future action of your members, what added factor is there besides the ability of the third market or the progress of the third market to be able to become more sophisticated in handling your transactions?

Mr. BRADFORD. The big factor that we do not know is exactly what the effect of competitive rates are going to be.

Senator BIDEN. You do not know what other people are going to do; is that what you are saying?

Mr. BRADFORD. We do not know what we are going to be able to do. We are going to have to negotiate every commission.

If we are doing that, we can get negotiated out of a commission or have it negotiated way down, especially when we're dealing with an institution. One way to avoid negotiating commissions is to get off the exchange and deal against them, that is, buy or sell as principal for our own account.

Senator BIDEN. Do you have any written statements from any of your members saying they will move to the third market?

Mr. BRADFORD. I do not believe we do.

Senator BIDEN. Do you have any firm indications of the probability of any of your members saying that?

Mr. SHERRILL. I can only speak for myself in this regard. To the best of my knowledge, I do not believe this association has received directly any firm statements or strong indications under what conditions firms would leave exchanges.

However, there have been statements made by several sizable firms in the industry that they must give it serious consideration if certain events take place.

Senator BIDEN. Can you describe for me those events?

Mr. SHERRILL. First of all, if the auction market erodes to the point where we do not consider it to be a viable market.

Senator BIDEN. What constitutes erosion?

Mr. SHERRILL. The loss of liquidity in the market.

Senator BIDEN. To what degree?

Mr. SHERRILL. That is a question we will have to look at and make a judgment in light of circumstances at the time.

Senator BIDEN. Can you write a scenario for me explaining under what specific conditions you would leave?

Mr. SHERRILL. I can give you a very specific set of circumstances.

If we were attempting to do business in an auction market that was not liquid and we were not able to operate a profitable business for Shields & Co. and if we made a judgment at that time we could conduct our affairs in the so-called third market on a profitable basis, we would not hesitate to leave the New York Stock Exchange.

When I say, "A profitable basis," that means the difference between red and black.

Senator BIDEN. How about "liquidity"? What does that mean?

Mr. SHERRILL. That is, again, a determination of which I am afraid there are not any definitive measures.

Senator BIDEN. What would be your definitive measure?

Mr. SHERRILL. When we felt that we could better service our customers in the third market, get better service, better execution and buy securities better—I mean not only price, but also in size—in the third market, that would then mean to us that the auction process on the New York Stock Exchange was an inferior market.

At that time, we would leave.

Senator BROCK. Aren't you really saying that if that happens, that Bradford left and Shields left and so on, that very shortly, we would have a Nashville Stock Exchange to replace the New York Stock Exchange?

Mr. BRADFORD. This is true.

However, you would not have the auction market. It would be very much like what you have got in Europe right now.

Senator BROCK. I do not understand because it seems to me that even the auction market can be broadly defined to include the third market in a sense.

Mr. BRADFORD. The auction market——

Senator BROCK. If you make the third market broadly expanded enough, we are in an auction market situation, are we not, and do you not then have to create the mechanism for those exchanges?

Mr. BRADFORD. Senator, the over-the-counter market is the best example of the dealer market that we have right now. Trades can be happening in several different places at several different prices and the buyers and sellers are not necessarily brought together at the cheapest prices.

There is not enough volume in the over-the-comunter market to justify bringing all these to one floor and having an auction market.

Senator BROCK. Haven't you just told the Senator from Delaware that if enough of them leave, there would be more volume there than in the New York Stock Exchange?

Mr. BRADFORD. Absolutely.

Senator BROCK. A lack of sellers and a lack of buyers?

Mr. BRADFORD. That is exactly it.

Senator BROCK. And you are back to another exchange.

Mr. BRADFORD. That is exactly what we're trying to keep from happening.

Senator BROCK. I understand.

Mr. SHERRILL. We are operating today under the same assumption as most of the people who have testified before this committee, the House subcommittee, the Treasury Department and other regulatory bodies. We have concluded, and most of those bodies have also come to the conclusion, that the auction process is a very valuable asset and that the auction market is a national asset and we must try to retain it.

When we get to talking about moving into dealer markets, you are then talking about the elimination of the auction market, and this would be bad for individual investors.

If we would come to the conclusion that a dealer market was the type market that served our institutional customers best, however, we would not hesitate. This association in the past has strongly supported the retention of the auction market process.

Senator BIDEN. There have been some who have suggested that the move away from fixed rates will have the exact opposite effect you are predicting. That is, that change will encourage trading on the floor of exchanges as opposed to away from it because of the absence of fixed commissions. The result would be a trading advantage for the auction markets.

I assume you think that is not likely?

Mr. BRADFORD. We hope that that will happen. What we are concerned with here is if that does not happen. Right now, we have got a business where we know we will get a commission. We know what we can earn and if we sell someone a stock, we get paid for it.

We do not know what is going to happen if we have to negotiate for every trade.

Senator BIDEN. Am I correct in understanding that it has been the

consistent position of your organization that you do not want to go to negotiated rates, period, under any circumstances, and that now you support this legislation—since you lost that fight—as a failsafe mechanism?

Mr. BRADFORD. That is right.

Senator BIDEN. I would like each of you to answer this one. I would like the answer for the organization first, and I want each of you to answer for yourselves.

Do you believe that the third market is an essential component for competition within the securities industry?

Mr. SHERRILL. I can answer this question as it pertains to the policy position that the SIA has followed. I will answer it first for the association. Then I will answer for my firm.

I do not think that the third market is necessary to stimulate competition in listed securities. Vigorous competition already exists. We have followed that policy consistently.

I do not think the association has changed one iota from its initial stand in this matter.

As far as Shields & Co., is concerned, I must say that I feel exactly the same way about it.

Mr. BRADFORD. I would have to agree with that. I see no reason why the third market cannot function under the auction market if you take away the minimum commissions.

Mr. SCRIBNER. Mr. Sherrill spoke for the SIA.

Senator WILLIAMS. I regret that I was unable to be here for your opening presentation. We have talked auction market-dealer market throughout these hearings. I am not sure, however, if at any point we ever arrived at a description for the record just what the definition is or the differences are between the auction market and the dealer market.

Mr. Sherrill, would you give us the definition of the auction market and the dealer market?

Mr. SHERRILL. I am giving you my interpretation of that definition.

An auction market is a public marketplace where buyers and sellers get together, orders are matched and purchases and sales are made at the best prices available. It does not necessarily have to be at one physical spot, but at least all buy and sell orders can be shown together. It is a market in which a dealer or a principal is not interposed.

The dealer market is a market in which a securities dealer acting as a principal buys and sells securities. He buys from a customer or perhaps from another dealer and he sells securities out of his principal position inventory to another party.

That is the simplest definition of it. I am sure it can be expanded, but that is the basic principal of it.

Senator WILLIAMS. The third market is, to what degree, a dealer market? 100 percent? 90 percent?

Mr. SHERRILL. I do not know the statistics on that. We have always considered it in our terminology as being a dealer market just as we consider the specialists on the floor in effect to be a dealer when he buys securities into his inventory and sells securities out of his inventory.

What percent the third market does, I do not know. I assume that very little of their business is done on a so-called agency basis.

Senator WILLIAMS. The agency principle is the essential business of the auction market?

Mr. SHERRILL. That is correct.

Senator WILLIAMS. Now, within these two areas, there are certainly differences and one of the significant differences that we discussed yesterday was the difference in the rules and regulations the markets live by and live under. The third market is not subject to regulation dealing with manipulative practices or requiring fair and orderly markets that the exchange markets, the auction markets, live under and abide by.

I tried to elicit testimony from the Chairman of the SEC yesterday on any movement toward equal regulation and I am afraid it was not too clear. Two of the things that are not at all clear is, first, where we are going and, second, how fast we are going to get there. The answers were not clear at all.

What are your impressions of this difference in regulation? Specifically, would this inequality of regulation be one of the incentives to leave an exchange when the rates become competitively determined?

Mr. SHERRILL. Senator, I may have answered part of this prior to your entrance into the room. But, I prefaced our testimony by stating that we, as an association, wholeheartedly concur with the introductory statements that you made yesterday as they pertain to equality of regulation. We believe in competition because we compete very fiercely among ourselves.

However, we do feel that in the past and currently, there are two sets of standards that exist in the industry, one of which we, as exchange members, abide by and which was created primarily to protect the individual investor.

The third market today is exempt from certain of those regulations—as a matter of fact, from most of them that you outlined yesterday.

Whether or not your bill is passed as it is written, I feel that it is essential that the SEC discontinue the attitude of turning their back on this problem. I would strongly suggest that they take very strong steps toward a set of equal rules and regulations.

If they did have equal regulations in most of the areas that you have discussed, perhaps one of the incentives for a firm leaving the New York Stock Exchange would be removed.

On the other hand, I do not think that the establishment of equal regulations alone would necessarily prevent the erosion of the auction market. I still feel, as it pertains to your bill, that the SEC should have this fail-safe mechanism.

Senator WILLIAMS. Has there been any discussion earlier of the alternatives to the bill, either the suggestions of the Treasury Department or the Justice Department?

Mr. SCRIBNER. No, sir.

Senator WILLIAMS. Are you familiar with the Treasury Department's many optioned approach?

Mr. SHERRILL. I have not read the testimony, but I know generally—if I understand it correctly—they have suggested that the SEC have a range of options open to them and not necessarily be limited to requiring that all listed securities traded on exchanges.

Senator WILLIAMS. Have you had time to digest that idea for any opinion or evaluation?

Mr. SHERRILL. On the part of the SIA, we feel that your bill, as it is written, is still terribly important to the preservation of the auction market process. We believe that the mandate given to the SEC should be restricted in the manner that you have stated in your bill because we cannot see at this time where any alternatives open would achieve the same effect that would be accomplished by having all listed securities traded on the exchanges.

Senator WILLIAMS. Anything further, gentlemen?

Senator BROCK. Can I go back on a couple of things?

Could you give me some examples of the kind of abuses which have, or might, occur in the third market which would lead to the conclusion that they have got to have more regulations?

Mr. SHERRILL. I can give you a brief example of several situations that exist today which we created by the disparity between the regulations that the third market firms operate under and that members of the New York Stock Exchange operate under.

My firm, Shield & Co., is a rather substantial firm in what is known as the block trading business. The third market firms today do not have to report their trades on a tape. I realize that a consolidated tape is underway, but it is not in operation yet.

Today, a third market firm can buy 100,000 shares of a stock selling at $50 a share. They can pay $47 for that stock. The last transaction on the New York Stock Exchange still remains at $50 a share. The $47 a share never prints.

If Shields & Co. does that transaction, the stock prints at $47 and we own 100,000 shares that last showed at $47 and not at $50. There is a great deal of difference in those two type transactions as they pertain to the two firms.

Secondly, when the third market firm purchases that block of stock at $47, as Mr. Bradford has pointed out, Aunt Jenney in Chattanooga is not able to participate in that transaction.

If that transaction occurred on the New York Stock Exchange, all the unfilled public orders on the book are taken care of at the same price with the exception, I think, of the first 100 shares. All those orders would be filled at the same price, $47.

Senator BROCK. Let us take a situation where you have a very large block of shares, 100,000 shares of GM or maybe some smaller company and you want to sell all the shares.

You do not want to do it on the market because you would destroy the market temporarily. The very magnitude of the sale is disruptive. You find yourself a friend across town that wants to buy 100,000 shares and he has got a ton of money.

So, you make your trade. Isn't that beneficial to both parties?

Mr. SHERRILL. It might be beneficial to both of those parties, and it might be beneficial to certain other parties, but I think the public investor as well as all investors are entitled to know at what price a transaction is taking place.

This is one of the basic standards that the SEC has set up and that is one of full disclosure.

If you have a transaction of this nature, I think not only is the public entitled to know about it, even though it may result in a deteriora-

tion in the price of that particular stock, I think they are also entitled to participate in the trade if they want to.

Senator BROCK. Mr. Sherrill, I think you know I am not unsympathetic to what you are saying and your posture. But, I have some points of confusion, like my friend from Delaware over there, and I just am having some trouble getting a handle on just how to resolve the thing.

I am not sure I understand what the difference is between a share of stock in an automobile or a refrigerator. If I can buy a refrigerator without going on the big board, I will do it.

I do not know why I cannot sell my brother if I can con him into buying some Brach Candy Co. stock at a high price why can't I just sell it to him?

Mr. BRADFORD. That does not make your brother feel very good.

Senator BROCK. There are very few transactions in which both parties do not think they see an advantage, or they would not engage in the transaction.

I find it very difficult to see how we can regulate that kind of transaction.

Mr. SHERRILL. I think here, Senator, perhaps you may be referring to what we call in the industry the fourth market, and that is the market where two institutions or two individuals effect a trade without employing a broker or without going in to the public securities market.

There is nothing today that exists as far as I know in the regulations that prevents one bank from selling 100,000 shares of stock directly to another bank without using the facilities of a professional in the business. That is the fourth market, and that is distinguished from the third market.

Senator BROCK. I think one of our problems is the semantical problem. In the subcommitte report that was written last April, it said it is not right to talk of the New York Stock Exchange as a true auction market.

You have got a mixture, and our objective is to come up with a national market system that is equitable and fair for everybody.

You may have some other examples of abuses that I was talking about earlier, Mr. Bradford.

Mr. BRADFORD. Most of the abuses are pretty technical, and I imagine the New York Stock Exchange can elaborate on them better than I can.

One big difference is that the dealer market has no real mechanism for handling open limit orders. The stock exchange is very well geared to do this, which at a great cost and inconvenience to us is very helpful to many investors.

The auction market is trying to let the little guy participate in the market on the same basis as the big guy. It is the best way that this can be done.

Aunt Jenny, if she is paying $50 a share when someone else is paying $47 a share, Aunt Jenny isn't too happy with the way she has been treated.

We feel she should be able to get the same price as the big person.

Senator BIDEN. Gentlemen, as representatives of the SIA you have taken a firm and consistent position on whether or not trading in listed securities should be confined to exchanges. What percentage of your organization disagrees with the position you have taken?

Mr. SHERRILL. I cannot give you the exact figures. I would say that an overwhelming majority of the members of the SLA support that policy.

Senator BIDEN. Some of the larger members, like Goldman-Sachs do not support that position, do they?

Mr. SHERRILL. Goldman-Sachs is one member. We have 745. I was not aware that Goldman-Sachs did not support that policy.

Senator BIDEN. That is the question I am asking you.

Mr. BRADFORD. I think they do, do they not?

Mr. SHERRILL. I think they do, but I cannot speak for them.

Mr. SCRIBNER. I do not know about any specific firm. Our portfolio does not consist of representing any particular firm or group of firms, but to voice industry positions that have been developed over time and after study by men such as these with me at the table. I think the position with regard to the trading of all listed securities on the exchanges has a strong consensus behind it.

It has been deliberated and discussed on many occasions within our governing council and board, and I think it does represent the strong feeling of the industry.

Senator BIDEN. We were discussing earlier the question of whether or not moving to negotiated rates is going to move your members away from trading on the exchanges or to them.

In the testimony in the *Thill* case, I understand the chairman of the board of Merrill-Lynch, and Mr. Levy of Goldman-Sachs, among others, I believe, indicated it might very well have the exact opposite effect.

I would like to read from prepared testimony which has been submited for later presentation:

> Fixed commissions are one of the causes of trade leaving the New York Stock Exchange and going to the third market. Continuing market rates will make it more difficult for member firms to exit.

This is a quote from the testimony of Mr. Levy.

> Upon further reflection since that time as a result of my experience with negotiated commissions on large industries, I have changed my views regarding the desirability of moving to the negotiated rates. It would not necessarily follow that the competitive commission rates on transactions of all sizes would have an adverse effect.
>
> Having negotiated commissions would not cause my firm to leave the New York Stock Exchange.

These men represent quite large member firms, don't they?

Mr. SHERRILL. Yes, they do.

Senator BIDEN. Is there a difference of point of view within your organization between relatively larger and smaller member firms?

Mr. SHERRILL. I do not think that that really is germane to the decision that these gentlemen have arrived at.

What we are afraid of is they might be wrong. All we are asking for is that a mechanism be set up which in the event that these seers have made a mistake, will prevent the destruction of the auction market.

Senator WILLIAMS. There is a vote in the Senate. I think we will break now and then return to the panel of Mr. James Needham and Mr. Owens.

We have an ambitious schedule ahead of us, gentlemen. We have to move rapidly when we return after this vote.

[Recess.]

Senator WILLIAMS. All right we will resume immediately.

Mr. James Needham, chairman, New York Stock Exchange, and author; Mr. Cornelius Owens, executive vice president of American Telephone & Telegraph Co. and now on the board of directors of the New York Stock Exchange; and Mr. Donald Calvin, vice president of the New York Stock Exchange.

STATEMENT OF JAMES J. NEEDHAM, CHAIRMAN, NEW YORK STOCK EXCHANGE, ACCOMPANIED BY CORNELIUS OWENS, EXECUTIVE VICE PRESIDENT, AMERICAN TELEPHONE & TELEGRAPH CO., AND BOARD OF DIRECTORS, NEW YORK STOCK EXCHANGE; AND DONALD L. CALVIN, VICE PRESIDENT, NEW YORK STOCK EXCHANGE

Mr. NEEDHAM. With your permission, Mr. Chairman, I will submit my statement for the record.

Senator WILLIAMS. Fine (see p. 98).

Mr. NEEDHAM. Mr. Owens, in addition to being one of our most distinguished directors is executive vice president of the American Telephone & Telegraph Co. He has been a member of the exchange board since 1968 and headed the special committee whose report led to the 1972 reorganization of the exchange's governing structure. Following the conclusion of my remarks, he will offer some further brief comments on the need for this legislation.

We are pleased to have the opportunity to appear at these hearings to express the support of the board of directors of the New York Stock Exchange for S. 3126.

May I say at the outset that we appreciate the concern shown by the entire committee in this matter of appropriate safeguards for public trading on the Nation's stock exchanges—and particularly by you, Mr. Chairman, by the bill's cosponsors, Senator Alan Cranston and Senator Bill Brock, and especially by the entire staff of the committee.

When the provision which is now S. 3126 was under consideration as a possible amendment to S. 2519, the exchange's board had an opportunity to review it in depth. At that time, the board took the position that while the proposal did not go as far as the board would have liked with respect to preserving the securities auction markets, it did represent a fair compromise which merited the exchange's support. Our position today is the same.

Rather than restate the concerns which we presented in great detail to this subcommittee in our appearance at hearings on S. 2519 last November, I would like to focus today on the essential public-interest aspects of this issue.

At the heart of S. 3126 is the public policy determination that it is in the vital interests of more than 30 million American investors to preserve the public exchange auction markets in this country.

There is near universal agreement on this point. You, Mr. Chairman, stressed it when you introduced the National Securities Market System Act on the floor of the Senate last October. The hearing record on that bill is filled with specific affirmations by the SEC and by representatives of the securities industry.

Mr. Chairman, the text of the various comments of the SEC and Treasury on this point are in my prepared text. In addition I would

note the chairman's comment to the Senate on March 6 when you described S. 3126 as "a major piece of securities legislation which will go a long way toward spending the development of a central market system and bolstering investor confidence in the markets."

The SEC has underscored the fact that the element of public confidence so vital to individual participation in the securities markets is not well served by dealer markets. Consider this illuminating description of a dealer market from the Commission's March 1973 white paper:

> Presumably, the classic example of a dealer market is the over-the-counter market, in which it is virtually impossible for an investor's order to be executed without the participation of a dealer in the transaction. There is no facility whereby public orders can offset each other, except under the auspices of a market maker, and this rarely occurs. Since the intervention of a dealer involves an additional spread between the prices at which investors can buy and sell, it is likely that in many instances investors obtain less favorable prices on their trades than if they could trade with other investors.

By contrast, the advantages of a public exchange auction market may be demonstrated by describing simply how transactions are handled on a stock exchange.

In an exchange auction market, all public orders are treated fairly—with the first order received at the best price receiving priority over other orders. This is so regardless of whether that order is from an individual investor purchasing 100 shares of stock or from an institution buying 10,000 shares. Moreover—and this is a terribly important point—all public investors can participate in any transaction in the auction market to the extent that they are willing to enter better bids than anyone else or succeed in reaching the market before anyone else.

This, very simply, is the auction which is conducted openly, the results of which are immediately reported to the world via the ticker tape. An investor watching the tape can see that his transaction was completed at a price which was the same as, or related to, other prices which preceded his purchase or sale.

This auction, therefore, combines the elements of fairness, orderliness, full disclosure and equal treatment and is designed to do so in a way that builds individual investor confidence in the market mechanism.

Accordingly, the central issue addressed by the bill is whether the orders of public investors in listed stocks should be exposed to all other orders of public investors in those stocks. This is what happens in a public exchange auction market—regardless of whether the investor happens to be a private citizen of modest means or a multi-billion-dollar institution. This does not happen in the over-the-counter dealer market in listed stocks—in the so-called third market.

The primarily institutional third market has little, if any, individual participation. In that market, an institution typically will sell listed stock directly to a dealer who, in turn, will sell it to an institutional buyer. Conversely, the third market dealer may buy stock directly from an institution and subsequently sell it either directly and privately to another institution, or publicly on the floor of the stock exchange. All of these transactions between dealers and institutions take place in the privacy of the dealer's office—or, if you will, in secret.

This secrecy factor which is a characteristic of dealer markets will continue to prevail even when a consolidated tape becomes operative because disclosure of a trade after it takes place will not change the fact that individual public investors do not have the opportunity to participate in it.

Moreover, dealer markets are in practice less stable than auction markets as explained in my statement. As you know because of the secrecy of third market trading, there is very little publicly available data on the nature and extent of their activities.

Currently, the only publicly available data on third market transactions is based on quarterly reports filed with the SEC, a summary of which is released by the SEC without verification.

These data show, for example, that in the fourth quarter of 1973, total third market trading amounted to 5.4 percent of the share volume and 6.6 percent of the dollar volume of all trading on the New York Stock Exchange.

As you know, the exchange and others have expressed deep concern that the advent of fully competitive commission rates will give broker-dealers compelling reasons of economic self-interest to leave the exchanges and act as over-the-counter dealers in listed stocks. We have repeatedly expressed our great concern that this will trigger an inevitable decline in the quality of the existing exchange auction markets and in the services available to individual investors.

S. 3126 speaks to this concern. The bill provides, as Senator Williams, Senator Tower, and others have said a "fail-safe" mechanism by giving the SEC the authority to require that all trades by broker-dealers in listed securities be effected on registered national stock exchanges if the SEC makes certain findings.

The bill provides that the Commission "shall" adopt a rule prohibiting broker-dealers from effecting transactions in listed securities other than on a national securities exchange. It has been suggested that the word "may" be substituted for "shall," to give the Commission greater latitude in deciding what action to take.

But this would also lead inevitably to a degree of uncertainty that seems inconsistent with the intent of the bill. It seems clear that the public interest supports the preservation of the exchange auction markets as a matter of national policy. If the SEC should decide, however, that some other way of achieving the objectives of a national market system is feasible, S. 3126 allows for such an alternative by providing in subsection (3) that the rule imposed by the Commission "shall not remain in effect after the Commission has determined that a national market system for securities has been established."

Accordingly, we prefer the word "shall," which provides for certainty for the near term without undermining the Commission's authority to decide on an alternative approach, should one be developed, in creating a national market system.

Further S. 3126 does not restrict or eliminate the Commission's authority to take alternative action under various provisions of S. 2519. These would include, for example, regulating dealers, imposing equal rules and regulations in all markets and regulating nonexchange members who bring transactions to the exchanges.

Therefore, the crucial policy question raised by S. 3126 is what, if any, developments should trigger the requirement that all trades in listed securities be effected on the national stock exchanges?

S. 3126 places the burden of triggering the requirement on the Commission. The Commission must find, after notice and opportunity for hearings, that the fairness and orderliness of the exchange markets or the self-regulatory capabilities of the exchanges have been or are likely to be affected in a manner detrimental to the public interest by over-the-counter trading in listed securities; and (2) no rule of any exchange would unreasonably impair the operations of existing third-market dealers, which would be integrated into the exchange markets, or unreasonably restrict competition in the exchange markets.

While these triggering provisions seem fair, they are also troublesome. Our board believes, and has publicly stated on many occasions, that the public interest would be best served by requiring all transactions in listed securities effected by broker-dealers to be exposed to all other such transactions.

The problem with the triggering provisions of the bill is that they require a determination that the fairness and orderliness of the public auction markets have been—or are likely to be—impaired, in terms of the public interest, before the Commission can act. Understandably, we would like to see action taken before the markets are adversely affected.

Ideally, we would like to see the possibility of damage to the auction market mechanism avoided either by having Congress determine now, as a matter of policy, that it will not be permitted to occur, or by writing specific triggering conditions into the bill which will impose the requirement before any damage can be done to our capital markets.

Obviously, these or any comparable remedial approaches would require a public policy determination by this committee and the Congress.

We recognize, as I stated at the outset, that S. 3126 offers a reasonable compromise solution to the problems we have outlined, and it is for this reason that our board supports the bill. We would not, however, want to see S. 3126 weakened in any way. What I am saying is that if revisions are to be made, we would urge that the bill be strengthened rather than weakened.

Again, on behalf of our entire board, I want to express our appreciation for the time and attention and thoughtful analysis the committee and its staff have given and are continuing to give to this issue.

Mr. Chairman, Mr. Owens has some remarks and with your permission he will proceed.

Senator WILLIAMS. All right.

Mr. OWENS. Thank you, Mr. Chairman.

My name is Cornelius W. Owens. I am executive vice president of American Telephone & Telegraph Co., and a public director of the New York Stock Exchange, Inc.

By way of background, I should add that I served as a public governor of the New York Stock Exchange from 1968 to 1972, and as chairman of the Special Committee on Exchange Reorganization. That committee submitted the basic report which led to the restructuring of the exchange's governing board in May 1972 and I have served since then as one of the exchange's 10 public directors.

I have been continuously and closely involved from the outset in the development of exchange policy with regard to the creation of a national—or central—securities market system. Therefore, I particu-

larly appreciate this subcommittee's courtesy in permitting me to comment on the legislation you are now considering—S. 3126.

I offer these comments not as someone who is involved in the day-to-day activities of the securities industry—but, rather, as a representative of the public who has had the opportunity over the past 6 years to play an active part in determining the policies which govern the New York Stock Exchange.

The importance of preserving and insuring the viability of our capital markets cannot be overemphasized. According to one recent estimate, the capital needs of corporate America between now and 1985 will reach an astounding $3.3 trillion. And I believe that estimate was made without full reference to the capital impact of the current energy situation.

Where is that money going to come from?

Others have documented the fact that corporate America is already heavily in debt. Economists tell us that inflation has severely compressed the value and diminished the prospective role of corporate retained earnings in financing economic growth and expansion.

The business community is becoming increasingly aware that unless the equity markets are able to fill the ever-widening gap between capital demand and capital supply, the Nation may face a serious shortage of capital at a time when it is most desperately needed.

This is the economic environment in which Congress is now preparing to restructure the U.S. equity markets.

The critical question, therefore, as I see it, is not whether the creation of a national market system will help one brokerage firm to prosper or cause another to go out of business—although, obviously, those questions are vital to the firms involved—but the really critical question is whether or not the securities industry overall is going to be healthy enough to play an essential role in helping Corporate America raise the vast amounts of capital needed to maintain and accelerate our national economic progress.

As the capital markets in this country are currently structured, the equity capital needs of America cannot possibly be met without the active participation of millions of individual investors—and a further broadening of the base of corporate ownership. And unless the equity markets are able to operate along lines that will actively encourage rather than diminish individual participation, the approach to a national securities market system could raise serious barriers to achieving the desirable goals identified by Congress.

The success of restructuring the securities markets, then, will depend not on whether the New York Stock Exchange and the rest of the securities industry believe that the best possible job has been done; not on whether the 3,200 listed corporations think the best possible job has been done; and not, even, on whether Congress thinks the best possible job has been done.

The success of the effort will have to be judged, ultimately, by whether or not 30 million or more American investors find themselves in an environment that they regard as hospitable to their investment dollars.

In the past, many companies have been successful in obtaining the use of vast amounts of investment capital from the American people. To a great extent, investors will put their capital at risk in a partic-

ular corporate enterprise because they have for one reason or another confidence in the management and policies which guide that company's activities and because they hope to share in its success.

But there is a much broader element of confidence involved when millions of individuals channel part of their savings into equity investments. That element of investor confidence is firmly grounded in the awareness that the existing securities market system in this country—whatever its imperfections—works for them.

They know that the system as it presently operates—the securities auction market system—is centered in a marketplace where they can buy and sell the stocks of listed corporations, at fair prices at all times.

The stock exchanges have pointed out that the two-way securities auction process—made up of bids to buy and offers to sell—provides both buyers and sellers with the best prices available at a given moment; and the exchanges have correctly stressed that the stock prices generated in this auction process give investors and corporate issuers alike a continuous, accurate overview of what the public thinks those stocks are worth at that particular point in time.

A particular corporation may not be pleased by what that continuing public opinion poll tells it at a given moment—but it does know how favorably or unfavorably its stocks are regarded. And that knowledge is immensely valuable to corporate management in determining both short-range and long-range corporate policy.

When we confront the prospect that a changeover to a dealer-oriented, primarily institutional market must inevitably alienate large numbers of individual investors, we are forced to recognized two very likely consequences:

First, a dealer market system will substantially deprive corporations of the breadth of judgment that keeps them accurately and continuously informed about the supply and demand factors governing trading in their stocks, and that leaves little doubt about what the public thinks of their performance.

And second, a dealer market will force corporations to rely increasingly on the narrow judgments of a relative handful of professional buyers and sellers whose possibly faulty assessment of supply and demand may also be influenced by the State of their own inventories in particular stocks.

If dealer markets proliferate, every listed corporation will have to depend more and more heavily on institutions and other large investors to take up the slack in the supply of investment capital created by the departure of disgruntled individual investors from the market—with all the consequences that implies.

That prospect is not at all encouraging. My own informal conversations with other corporate officials indicate that concern is both widespread and deep.

As a Director of the New York Stock Exchange, I am well aware that certain reservations have been expressed about the validity of the Exchange's warning that a changeover to fully competitive securities commission rates can, in the absence of appropriate safeguards, trigger a chain of events that could have a devastating effect on the securities auction markets and on public confidence in the stock market generally.

I personally find those warnings all too persuasive—particularly

with regard to the likelihood that individual investors will desert the market and that corporations will face the very real threat of institutional domination.

There is, as we all know, a strong tendency in some quarters to distrust bigness in business.

Senator WILLIAMS. Mr. Owens, I regret this but we have to go over and vote. We will recess and return.

Mr. OWENS. I understand.

[Recess.]

Senator WILLIAMS. Now, with a little luck, we can be undivided in our attention.

Mr. OWENS. Thank you, sir.

Senator WILLIAMS. You may resume.

Mr. OWENS. There is, as we all know, a strong tendency in some quarters to distrust bigness in business. At the same time, there is ample evidence to demonstrate that bigness, properly managed and with adequate safeguards, can strongly advance the public and national interest.

As I see it, Congress, in seeking to create a national securities market system, recognizes that this is an area in which bigness and consolidation of vital services can indeed strengthen and improve service to the public. At the same time, there seems to be a paradoxical reluctance, in some quarters, to take the necessary steps to insure that this big national system will operate as effectively as possible.

And I cannot help but wonder—I cannot help but share the concern of many of my colleagues in the corporate community—that this reluctance could, in turn, launch the U.S. securities industry on the road to major desirable improvements with insufficient attention to the perils likely to be encountered along that road.

As you know, it was more than a year ago that the Exchange's board first identified the crucial threat to the auction markets posed by the prospective unfixing of commission rates. At that time, I strongly supported—as did the other public directors—the proposal that concurrently with the changeover all trades of listed securities should be required to take place on registered national securities exchanges.

That proposal is, of course, at the heart of the legislation this subcommittee is now considering. It seems clear to me that you also are concerned that basically sound legislation could inadvertently produce harmful effects. In all frankness, I must add that this evidence of your concern helps to dispel some of ours.

I believe Corporate America would breath more easily—and the interests of 30 million or more individual investors would be better served—if the specific safeguards recommended by the New York Stock Exchange's Board of Directors could be written directly into the legislation mandating the creation of a national securities market system.

If that is not possible, then, certainly, the "failsafe" mechanism provided by S. 3126 will at least minimize the likelihood of serious damage to the auction market system, to the corporate capital-raising capability and—most important—to the American investing public.

Mr. Chairman, may I again express my appreciation for this opportunity to present these comments to the subcommittee, and for your courteous attention. Thank you.

Senator WILLIAMS. We're very pleased that you joined us today and made your statement, Mr. Owens.

You mentioned your term; when did your term begin on the board?

Mr. OWENS. 1968—well, on the old board of governors, Senator, 1968. Then I was chairman of the special committee on Exchange reorganization and have been on the board of directors since the new reorganization.

Senator WILLIAMS. Now, Chairman Needham, a couple of questions.

We have been over much ground on this bill with other witnesses. I don't think we have to replow it all.

I would like to know what events would have to occur before the SEC should make its finding of "is likely to adversely affect the fairness or orderliness of the exchange markets." I am looking for your impressions of the kinds of events that would trigger the provisions of S. 3126.

Mr. NEEDHAM. Senator, I think that is probably the gut question here. Of course, our position very simply is that you shouldn't have to go through that agonizing procedure of trying to determine anything. The simple solution really is to require that all trading take place on an exchange; then you don't have to determine whether you want the investing public skewered 5 percent of the time or 10 percent of the time, or 15 percent of the time, which was being suggested earlier.

We feel the best protection is to make—you are asking me what I want, and I am telling you what I think is the best for the investing public. That is to require that all trading take place on an exchange.

Senator, I have been listening to the same dialogs that you have, and no one has given me a reason why we shouldn't do that.

I am not suggesting you should give me the reason, but I have not heard it from the witnesses as to what is wrong with such a requirement.

Senator WILLIAMS. I think the answer to that really is basic to everything we have been talking about. From the members questioning, I get the impression that they want to have that best evidence that there will be—assuming that it is not in the public interest to see the exchange adversely affected in terms of membership with an exodus of some degree—an effective remedy to preserve the auction markets.

They are looking for evidence that there will be an exodus that will change the nature of the auction market, the exchanges, and lead us into more and more reliance on a dealer market.

Mr. NEEDHAM. Well, Senator, I guess the one simple way to do it is to take the existing situation, and let's say, for example, that there is 5 percent of the trading of listed securities on other than a national securities exchange, and as soon as it gets to be 6 percent, you just require everybody to go right back to where they were. It would be that simple. Mr. Calvin feels he would like to make a comment. Would that be all right?

Senator WILLIAMS. Yes.

Mr. CALVIN. Thank you, Mr. Chairman.

This is a question that has been put to a number of witnesses and the simple answer is that there is no precise answer as to what the de-

terioration is that must take place in the auction markets before they are atrophied to the point where they cease to function in terms of the public interest.

However, we did point out in our earlier testimony on November 13 that if the 10 largest firms of the New York Stock Exchange took the business that they do today on the floor of the exchange back to their offices and acted as dealers, the result would be a decline of 31 percent of the transactions presently handled on the Exchange.

I think clearly that type of a development would lead to the disruption of the fairness and orderliness of the market; as I say, a 31-percent decline in the market transactions.

That would be accounted for by 10 firms moving away from the auction market and becoming dealers, only 10 firms.

So I guess you could observe that it depends on which 10 firms leave. If those 10 top firms leave, and you have a 31-percent decline in activity, clearly the orderliness would be affected.

Senator WILLIAMS. The members were speculating whether you have any evidence that some percentage of firms will leave after May 1, 1975, which is the announced date for the elimination of the fixed rate.

Mr. NEEDHAM. We know that Merrill, Lynch will leave. They have said it.

We know that Goldman, Sachs has said it; we know Paine, Webster has said it. We know that there will be tremendous pressure on the so-called institutional type firms to leave.

There will be no incentive for them to have their blocks taken down to the floor. So I think we are dealing with a very real situation. That is why when you ask me what should the criteria be, I say that is a very complicated question, and the better choice is to avoid the question, and the determination, and to enact it the way we suggested.

Senator WILLIAMS. Now, finally, would you deal with this disparity of regulation between the exchanges and the third market, and whether this disparity leads to any hard speculation of the effect on incentives to leave the exchange?

Mr. NEEDHAM. Yes. I will deal with that.

Let's deal with—and we can break it down into parts. The parts that I forget, Mr. Calvin will remember.

Let's talk about market-making responsibility. We have rules at the NYSE, requiring the specialists to make an orderly market. They have to be there every day.

In the third market there is no comparable regulation.

Second, we have rules governing the way the transaction takes place, and the way they are reported. Ultimately there will be the composite tape, but there will not be any surveillance—there is no surveillance at this moment of what goes on in the dealer market.

The NASD does not regulate the dealer markets the way we regulate the floor of the New York Stock Exchange, or the way that Midwest and PBW do it.

So they can move away from the market and not be there. They are just free of all the rules that we have about dominating the market as dealers.

So that everyone has been talking about the last couple years, anyway, about the need for uniform rules and regulations.

As you know, I personally believe these initiatives should start in the private sector. We arranged such a meeting at the exchange a couple months ago to see if we couldn't get people to start to work on this project of developing uniform rules and regulations. We had that meeting and a third market firm that was represented there was disruptive and unwilling and was an obstructionist, to any progress in the area of developing uniform rules and regulations.

So as a result of that, we had then to turn to the Federal Government and say we just can't get anyone to agree because of the obstructionist attitude of this one particular individual, so we have turned the problem back to the SEC.

So we have tried at the New York Stock Exchange to develop uniform rules and regulations. It isn't that we say all these rules must be the rules for everybody, but there has to be a starting point and we offer to sit down and talk with people about those rules on the basis of their merit.

Maybe we would end up discarding some of ours which might be considered anticompetitive or unduly restrictive in the context of a national market system. But we couldn't even get off first base with it.

Senator WILLIAMS. This is within the industry now?

Mr. NEEDHAM. That's right.

Senator WILLIAMS. What is happening in the area of equal regulation, either as a result of your efforts or the Commission's efforts?

Mr. NEEDHAM. The Commission wrote us a letter last August, saying they would see to it that there would be rules on short selling, antimanipulative practices, and on suspension of trading.

Nothing much has happened at the Commission since that letter came to us. But we have received assurances from time to time that the Commission was going to do something in the way of developing those rules. But nothing much has happened.

Senator WILLIAMS. I missed that——

Mr. NEEDHAM. We have received assurances that the Commission would develop those rules, but they never have.

Senator WILLIAMS. If there were equal regulation, where it is possible and desirable, would that change the picture concerning incentives to leave the exchange?

Mr. NEEDHAM. It would lessen it. It would lessen it. I still feel, Senator, that we are dealing with such a complex issue here that we ought to have a fail-safe device. It doesn't cost anything to have it. Certainly the SEC, who will make the administrative decision, will be qualified to make that decision and I just can't see any injury coming about as a result of it. It is a latent authority in the act if enacted which the SEC will use at the appropriate time.

Senator WILLIAMS. All right.

Mr. NEEDHAM. You know, Senator, may I——

Senator WILLIAMS. At any rate, the whole scene changes after the rates are freely competitive and we have the central market apparatus. Then the whole thing changes.

Mr. NEEDHAM. That's correct.

Senator WILLIAMS. So we are talking about an interim period.

Mr. NEEDHAM. Precisely.

Senator WILLIAMS. You were going to say something?

Mr. NEEDHAM. Yes, sir.

Many times, Senator, people have said that the New York Stock Exchange is trying to retain its monopoly position. The statement was made earlier this afternoon by a member firm of the New York Stock Exchange with respect to that.

The New York Stock Exchange is not a monopoly. But you know, it is interesting. One of the fears that has been expressed is that if this proposal that you have here in the form of this bill were to be enacted, it would force a third market firm out of business.

Senator, nothing could be further from the truth.

I have in front of me—let me just identify it for the record. It is identified as a prospectus and the number is W–258000 Weeden & Co., filed with the SEC January 17, 1973, received by the SEC office of records, January 19. It deals with the various employee plans of that firm.

Senator, it shows under sales and income on page 10 a comparison for the years 1968, 1969, 1970, and for the 9-month periods in 1970 and 1971 and I assume the numbers have not changed that much, it shows that this firm which is a major third market firm derived approximately—and it is difficult for me to read the numbers because of the photocopy—but it looks to me like about 39 percent of the gross revenues from its third market activities.

Now, it is inconceivable to me that you, the SEC, or we would write such rules that they had to get out of that business totally. But even if we did, it wouldn't put them out of business.

Let's take an analysis of Weeden & Co.'s income statement for the year 1973 and for the benefit of the record this is its annual report to stockholders for the year ended September 30, 1973. On page 5 of that report it shows for the year ended 1973 and 1972 securities sales—unaudited—and it shows the gross. I assume their net of $16 million in 1973, of which $5 million have to do with corporate stocks, one-third of their business.

Now, we don't know whether they are making markets in over-the-counter stocks. You know, there is little available on what a particular third market firm does. That doesn't indicate to me that they are going to go out of business. They are very creative people, they have told us, and I am sure they know how to adapt themselves to uniform rules and regulations that would be imposed on them through the central market system.

Now, I have an ad which is going to be introduced as evidence later on in this hearing put out by the same firm and interestingly enough, Senator, this firm does—they show breakdown of our volume by customer, for example; approximately—it is 19.9 percent of their total share volume is done on exchanges in the United States. So, this third market firm is utilizing the exchanges right now. So, what is the great hardship on the third market to require that they show their trades because of the other—the balance of their trading activity we assume is out of their dealer inventory directly to a bank, a mutual fund or other institution as they show it.

What is so contrary to the public interest to say to them—and we're not saying they have to become a member; we're saying "Take those orders down to a floor of a national securities exchange." We don't care where it is; they are members of every exchange except New York and American Exchange, and we are asking them to show those orders

to the crowd and to the book and clean up the public book. That is in the public interest. Why don't they want to do that?

Senator, they do business on the New York Stock Exchange, they say 2.7 percent of their transactions for their own account.

Well, Senator, we have an arrangement as the result of an edict by the SEC where we have to give nonmember broker dealers a 40-percent discount as long as they sign an agreement with us. That agreement has been signed by approximately 1,500 nonmember broker dealers. This third market firm hasn't signed it. That means that when they come on the floor of the New York Stock Exchange, they pay the full nonmember commission.

Now, it is a publicly held company. They have the opportunity to buy these stocks at a lower price but they are paying a higher price than they have to. They are not availing themselves of this discount.

Now, Senator, a number of questions come to my mind. Why would someone do that?

Senator WILLIAMS. You are not speaking to stock prices now. Rather, you are saying that they have the 40 percent commission discount available to them?

Mr. NEEDHAM. They get the same prices; it is the commission that is different.

Why would some firm want to do that?

I can conjure up a lot of reasons. These are reputable people. But one of the reasons could be that they don't want to subject themselves to our regulation which is what all of the 1,500 other people do. The others sign an agreement giving us the authority to examine their books and records.

Another reason might be that they are involved in extensive reciprocal practices with our own members where they meet them on other exchanges or cut them in on underwritings or something like that, and it gets washed out.

I am glad Senator Biden is back—and I put this question to you simply—I am concerned, I don't want to see the American public skewered 5 percent of the time or 10 percent of the time. I just would like someone to get on this record the answer to the questions I have just posed. I am sure there are answers to them and maybe after I have heard the answers I will understand it and won't be as concerned about it as I am right now. But I cannot understand why this proposal is being considered anticompetitive.

We're not asking them to join the exchange; we are not asking them to subject themselves to our regulation. They can still be subject to some regulation the NASD is presumably enforcing.

Why won't they do it? Why won't they cut the little guy in on their business? They are an institutional firm and that's it, pure and simple. Why won't they let the small guy participate in their business? That is the question that this subcommittee has to get an answer to and no other.

Senator WILLIAMS. We will probably get it after we answer that bell in just about 45 minutes.

Mr. NEEDHAM. OK.

VOICE. Forty.

Senator WILLIAMS. Did you say 40?

Thank you, very much.

Senator Biden?

Senator BIDEN. In your opinion, what series of events are there that would be required for the provisions of S. 3126 to become operative?

Mr. NEEDHAM. On the presumption that you are not willing to buy my argument that all trends ought to be there now, then I would say to you there is only one answer to your question.

Senator BIDEN. That is your present argument. That is the most recent one.

Mr. NEEDHAM. That is right. That is the public interest question. All you have to decide is how many times you want the public to be skewered.

Senator BIDEN. I assume that is the question that moved you from your previous position?

Mr. NEEDHAM. Well, we moved to it in the interests of getting some type of failsafe device, right.

I would say to you to cut it very simply, that given uniform rules and regulations and given the opportunity for third market firms of all types and descriptions to participate in the ordinary flow on any exchange that they want which we're willing to do, at least at the New York Stock Exchange, then I would say that if the percentage went from 5 to 6 percent I would move if I were a Commissioner of the SEC.

Senator BIDEN. That is a very specific answer; thank you.

With previous witnesses, I have asked the question whether negotiated rates will cause a flight from trading on the floor of exchanges to the third market. Do you think that will happen?

Mr. NEEDHAM. As a businessman, you have to say yes to that, Senator. The reason is very simple. The profit opportunities as a dealer are much greater than they are as a broker. This third market firm I am referring to here, and this is Weeden and Co. again in their annual report to their shareholders said that third market profits in 1973 were approximately equal to 1972 even though share volume decreased from the prior year.

Now, Senator, I can tell you that the member firm community of the New York Stock Exchange lost $49 million last year principally in the securities commission income aspect of their business. So, here this is—this is clear, indisputable fact that the dealer market is more profitable than an agency market. That is why the firms will leave.

Senator BIDEN. There have been firms that have indicated to you, I suspect, that they would leave.

Mr. NEEDHAM. That is right, and I mentioned them before, Senator. There were Merrill Lynch, Goldman-Sachs, Paine Webber, several of the institutional type firms.

Senator BIDEN. Can you tell me how recently that was indicated to you?

Mr. NEEDHAM. Since the middle of December, Senator, when the committee and subcommittee marked up S. 2519.

Senator BIDEN. Well, I am probably being provided information that is incorrect, then, because in rereading the testimony of Mr. Weeden prepared for presentation later today, he quotes, and I don't know what the date on this is, such firms as Goldman-Sachs as saying that that is not the case; they wouldn't leave. I guess—is that just a matter of dates? Is that why that is?

Mr. NEEDHAM. What you have in front of you is an adversary brief. In preparing an adversary brief, you are entitled to a great deal of

license. You are allowed to pick and choose the information you have in there. That is what you have there. You have statements made by people away from the dates I have just spoken about.

Senator BIDEN. I realize it is an adversary brief, but it is a direct quote. It was made under oath in an adversary proceeding which I have a little more faith in than some of our hearings which are not adversary enough in my opinion.

So I guess your explanation is, and I shall direct your answer to Mr. Weeden when he testifies, that even though there is a date on this testimony, it is apparently now the case that the statement of Goldman-Sachs is no longer operative.

Mr. NEEDHAM. You have to read the pages preceding and the interrogations of the—I think those are quotes from the Thill case, right?

Senator BIDEN. Right.

Mr. NEEDHAM. You have to read that record carefully and I suggest you have the staff do that because you may find the interrogations went one way and the answers were responsive to the question being asked, but not necessarily responsive to the question you are asking.

Senator BIDEN. It seems to me it is hard to misunderstand. "I have rejected the view and do not now believe that the advent of fully negotiated commission rates would be likely to cause my firm to leave the New York Stock Exchange—" no matter what preceded or what followed it.

Mr. NEEDHAM. Senator, Mr. Levy and Mr. Reagan are both members of the board of directors of the New York Stock Exchange; they were members of the board of directors on March 1, 1973. It was on that date that this policy was articulated for the first time by the board.

So, any of those statements if they precede that date I would say they are inoperative and inapplicable.

Senator BIDEN. I guess the easiest thing for me to do, since we have pointed out an apparent contradiction, is to ask directly those gentlemen, for example, Mr. Reagan of Merrill Lynch.

Mr. NEEDHAM. Because of your great interest in this, I would like to interrupt a moment.

I mentioned earlier when you were not here that you don't have to leave the exchange to have the event occur that we're concerned with here. Without this legislation, it would be possible for Merrill Lynch; you know they are a holding company, it has a variety of subsidiaries. It could have one subsidiary which would be a member of the New York Stock Exchange, and it could have a subsidiary that was not a member of the New York Stock Exchange, and that subsidiary could deal in the third market, wheel and deal just the way they wanted to while the other subsidiary would be subjected to our rules.

Do you follow me, Senator?

Senator BIDEN. Yes; I do, and I assume that if your statement is correct that would in part explain the apparent inconsistency that puzzles me. Here is another example: in a letter dated March 21, 1974, from William Salomon of Salomon Bros. to Senator Hart, Mr. Salomon says, and I quote, "Finally we have stated that we have no plans to resign our exchange membership after the advent of fully negotiated rates and have expressed disbelief that there would be a mass exodus of other exchange members. We still hold these views."

Now, that was March 21.

Mr. NEEDHAM. March 21 of this year?

Senator BIDEN. March 21, 1974.

Mr. NEEDHAM. I would say this, that if Billie Salomon said that March 21, he meant it.

Senator BIDEN. That is a definitive statement; thank you. I knew I would get some definitive statements.

Mr. NEEDHAM. Well, you wanted a more adversary proceeding, Senator.

Senator BIDEN. Well, I don't know how we can really interject this. I just got a note from Staff. "Merrill Lynch's representative has just come over and he insists," and it is underlined, "that their position is they will not leave the exchange." But we can find that out. We can get that in writing, I guess, by asking them that question.

But you have answered how you think that is sort of a red herring.

Mr. NEEDHAM. Is he on the board of directors?

Senator BIDEN. I don't know, but if he is wrong, he certainly won't be.

As I understand it, you really see no threat to the competitiveness of the securities industry if the third market were to be eliminated, or, in other words, if they were forced to effect transactions on the floor of the exchange. Is it your position that this would not in any way affect either the public interest or the interest of those who are involved in the industry other than third market firms that had to move?

Mr. NEEDHAM. Senator, we would love to have the third market firms become members of our exchange because they are in their own way competitive. They do have capital. That is the one thing they do have. The whole industry needs capital and to bring all that capital into one place has to result in a more liquid market. We would be in favor of that.

Senator BIDEN. I asked Chairman Garrett's opinion on some rules yesterday and I would like to ask your opinion on a couple if I could.

Rule 113, which prohibits specialists from dealing directly with certain kinds of customers. Could you comment generally on that?

Mr. NEEDHAM. Rule 113 as you may know, Senator, is a rule that was adopted by the New York Stock Exchange. The American Exchange's counterpart of the rule is 95. This was at the request of the SEC in order to make certain that the specialists did not become involved in certain antimanipulative types of activities.

It stemmed from the investigation, the Rey investigation of what happened at the American Exchange.

Now, the important part of that is not the generalization of the rule itself but that the rule has resulted in a structuring of the industry which seems to be acceptable to the members of the industry and it also seems to serve the public interest well.

Now, a lot of people are concerned that the third market firms who currently can make markets and then talk to the institutions, if they were subjected to rule 113 that that in effect would deny them some type of competition.

Well, I have two responses to that. First of all, the member firm community is going to have to alter some of its practices as well so it shouldn't be that the third market firm should escape reformation as well.

The second point is simply this: Weeden & Co., and I will come back to them because they are the only ones that publish ads like this, their profile of the breakdown of their volume by customer indicates to me that their profile is comparable—could be the same as the profile of any of our upstairs firms like Salomon Bros., Bear Stearns, or Goldman Sachs. Twenty percent of the activity of Weeden & Co. is done on the stock exchange. So, Weeden and Co. could have the ability if they were members or had access to the exchange, to conduct their business in the same fashion that they are conducting it now.

The only difference, Senator, is that they would have to bring their trades to the floor of the New York Stock Exchange and clean up the book which is what Goldman Sachs does, and Mr. Salomon's organizations does.

The unanswered question is, why won't the third market firms let the investing public, the little guy get in on those trades?

Senator BIDEN. Your concern for the little guy is admirable. So, Weeden & Co. could have the ability if they were A.T. & T.

Mr. OWENS. Right. I agree with you, Senator.

Senator BIDEN. Which is refreshing to know, you know.

How about rule 438, which prohibits dealers other than specialists from quoting a two-sided market.

Mr. NEEDHAM. I will let Mr. Calvin answer that one, if you don't mind, Senator.

Mr. CALVIN. Rule 438 is no problem at all in the context we are talking about. There are many other rules that would have to be addressed but this isn't one of them.

All this rule does is it says a member organization cannot advertise in quotation sheets. I don't know that that's any type of a problem at all in the context of integrating the third market and the exchange market. If it were, I am sure the rule would be revised or if the SEC would allow us to do so, would be repealed. It is just not a problem.

Senator BIDEN. How about the fact that memberships to the Exchange are available only on a medallion basis? I assume if this legislation went into effect, and the determination was made that it is time to implement it, the exchange would expect third-member firms to come in on a paying basis, is that correct?

Mr. NEEDHAM. Senator, I think the third market firms would be willing to pay their way. I have never heard them say they were not willing to pay.

Senator BIDEN. What if they did say that?

Mr. NEEDHAM. The problem is the seat, right? The House bill, H.R. 5050, clearly envisions, as does the SEC policy statement, that all broker-dealers, all eligible broker-dealers shall have access to the central market system.

Now, Senator, no one, I guess, really understood what that meant until recently. What that means is that the seat concept is eliminated, so in terms of the national market system there is no necessity for anybody to buy a seat any longer.

The problem we have, Senator, which Congressman Moss addresses, and I know Chairman Williams as well does, is how we reimburse the seatholders for their equity. That is a separate problem. We are working on it without much success.

Senator BIDEN. That is what I thought.

Mr. NEEDHAM. The bill does not require the third market firms to become members at all.

Senator BIDEN. I understand that. But yesterday I believe Commissioner Garrett indicated that if the Williams' bill were to be passed and the mechanism were triggered that something would have to be done about providing for the movement to the exchange without having to come up with the cash.

Mr. NEEDHAM. Senator, I don't know why the Commission arrives at this so late in the game. When I was a commissioner—and that seems like a hundred years ago ago—we dealt with that problem. We said it very clearly that there wasn't going to be an entry fee other than the usual initiation type fees and user type fees. The real problems—and I will state it again for the record—is what do I do about the equity which our members have at the present time, which amounts to $16 million? But that is not at issue here. This bill doesn't require they become members. All they have to do is bring their trades to the floor.

Senator BIDEN. If I understand you correctly, your position is that first of all they should be required to be there anyway regardless of this bill. You see no reason why the third market exists in the State that it now does nor should it.

You would like to see them members of the exchange.

Mr. NEEDHAM. Senator, in May 1971 before this committee cranked up its hearings, before the House cranked up its hearings, before the SEC did, I gave the whole world for what it was worth a blueprint of what the securities industry should do—how it should be restructured. All of this legislation is taking you right down the road of that blueprint.

Senator BIDEN. That is what the third market is telling me..

Mr. NEEDHAM. But the difference is, Senator, I reached that as a commissioner. At that time I had integrity. The point is——

Senator BIDEN. A noble admission.

Mr. NEEDHAM. Anything that fragments the securities markets of the United States ipso facto is detrimental to the public interest. That is the way I came out as a Commissioner; that is the way the Exchange board of directors came out.

Senator BIDEN. You view the existence of the third market as a fragmentation?

Mr. NEEDHAM. It's existing right now as, yes.

Senator BIDEN. So you know the basic premise from which you start is that they shouldn't exist because they are fragmenting the industry now and that they therefore should be members of the exchange.

Mr. NEEDHAM. Senator they should exist, the firms should exist.

Senator BIDEN. But not in the present format.

Mr. NEEDHAM. The third market shouldn't exist.

Senator BIDEN. That is right.

Mr. NEEDHAM. The record may not show it as clearly as I'd like it to. The last time I appeared here you asked me a question about the fourth market whether they should be required to be part of the national market system. I answered negatively because at that time we didn't think it was a problem.

But, Senator, that question has been haunting me for 4 months and you have convinced me the fourth market should be part of it.

Senator BIDEN. I thought you might come around to that. I really did. It really does my heart good to know that I can move you like that. But again for the record, am I correct that your basic premise is that the existence of the third market is by definition a fragmentation of the securities industry, consequently they should be members of the exchange?

Mr. NEEDHAM. And ultimately part of a national market system.

Senator BIDEN. Right, which are exchange markets, the way you view it.

Mr. NEEDHAM. Technically.

Senator BIDEN. Within the context of exchanges. So that secondly as I understand it would say that the fact of movement from fixed commission rates to negotiated rates barring any other action being taken is going to have the effect of further fragmenting the industry by moving people from the exchanges to the third market as it now exists.

Mr. NEEDHAM. That is correct, Senator.

Senator BIDEN. OK.

Now, you then go on to say that, if I understand you correctly, that the triggering mechanism of S. 3126 would become 5 to 6 percent of the trades now executed over the exchange were moved to the third market.

Mr. NEEDHAM. Absolutely. I gave you three points to start with.

Senator BIDEN. Okay. I appreciate that. In addition, you see this 5 to 6 percent decrease as inevitable. That is just a fait accompli as far as you are concerned.

Mr. NEEDHAM. That is right.

Senator BIDEN. So what you are saying now is that there is no question that the third market will be eliminated if this bill is passed.

Mr. NEEDHAM. That is not quite right.

Senator BIDEN. Wait a minute now. Tell me how it is not quite right.

Mr. NEEDHAM. Because if the bill goes through the way it is, I don't know what the SEC—what determination the SEC will make.

Senator BIDEN. I see. That is a good point.

You would like to have the bill tightened as I recall from the beginning of your testimony, to insure that their version would be coinciding more with your version of what would constitute the need to exert the trigger.

Mr. NEEDHAM. When I buy life insurance, I don't want the life insurance company telling me you are insured 95 percent of the time.

Senator BIDEN. I understand that. I want 100 percent and the insurance you want is elimination of the third market and you see this as a vehicle of being able to do that.

Mr. NEEDHAM. And also to make sure—as a result of this legislation plus S. 2519—that whatever noncompetitive or anticompetitive rules the New York Exchange may have will in the process be eliminated, so no one will be hurt——

Senator BIDEN. I understand your motivation is pure and pristine and to help the little guy and I know——

Mr. NEEDHAM. It isn't just pristine, no——

Senator BIDEN. But I want to make it clear, that your support of this bill, coupled with your language, is directed and has as its sole purpose the elimination of the third market. I want to make no mis-

take about that, and I want to make it clear for the record. You said we want to eliminate the third market; we missed it last time out and we will get it this time.

Senator BIDEN. I think it is important that that be stated.

Mr. NEEDHAM. I just want the record to show that you stated what you thought I said.

Senator BIDEN. OK, well, I think that reasonable men reading the record will have no mistake about what you said. But then again, you know, the reasonable man is becoming as scarce as Diogenes the honest man around here, so I don't know.

Mr. NEEDHAM. Senator, you recognize the bill as presently drafted does not do what you say it does.

Senator BIDEN. Well, it may not do assuming that the commissioners don't agree with you as to what constitutes the need to trigger the bill.

Mr. NEEDHAM. That is——

Senator BIDEN. But if they believe as you did, and if it's as inevitable as you say, then they end up where you do. But you will be able to take the record at a later date and say that that is not what you meant to say and I agree it is my conclusion being drawn from what you have said.

Mr. NEEDHAM. Senator, I just want to make something clear. I assume the line of questioning is designed to evoke answers from me and doesn't necessarily indicate your convictions because if I believed that the convictions—that the words you have just uttered were your convictions then I would have great difficulty trying to understand why any member of this committee voted for the national market system bill because that is a bill that is designed to eliminate fragmentation. I am opposed to fragmentation; the committee is opposed to fragmentation; how you express that I leave up to you.

Senator BIDEN. Let's talk about fragmentation for a moment.

If I own half the pie and you own half the pie, it is fragmented. If I want your half to be coupled up with my half on my table we are bringing it back together. If you want my half coupled up with your half on your table we are bringing it together, too. We have a central pie, all whole and full. It all depends on whose table it is on.

Mr. NEEDHAM. No, Senator, you don't understand the securities markets.

Senator BIDEN. You are right about that, I guess.

Mr. NEEDHAM. If you give me 5 minutes, I will make it absolutely clear to you as to what we are saying.

Senator BIDEN. The chairman has been very kind to me——

Senator WILLIAMS. It is all right with me, Senator Biden, as long as you stay through all the people that are left.

Senator BIDEN. I will ask one last question of Mr. Owens.

Mr. NEEDHAM. OK, you are the Senator. I think——

Senator BIDEN. Only for another 4 years though.

Mr. NEEDHAM. That is about the time my contract expires.

Senator BIDEN. Mr. Owens, you also expressed the need for providing the best advantage for trading by individual investors to promote depth and liquidity in the securities markets and that these are best represented in the exchange auction markets.

Did I understand your testimony?

Mr. OWENS. The general sense, yes.

Senator BIDEN. I am told, however, that your own company, A.T. & T., has an employee program which allows them to buy and sell A.T. & T. stock directly from the third market firms; is that correct?

Mr. OWENS. No; we do not buy from the third market as such. We have a reinvestment plan with respect to the share owners and they purchase stock and we purchase stock for them and they get the stock.

We have a savings plan whereby the—one of the choices is to buy A.T. & T. stock.

Now, where that is purchased, I don't know.

Senator BIDEN. OK. Thank you. You gentlemen have been very responsive. I appreciate it.

[Complete statement of Mr. Needham follows:]

STATEMENT OF THE NEW YORK STOCK EXCHANGE, INC.

My name is James J. Needham. I am Chairman of the Board of Directors of the New York Stock Exchange, Inc. With me today are Cornelius W. Owens, a Public Director of the Exchange, and Donald L. Calvin, Vice President.

Mr. Owens, in addition to being one of our most distinguished Directors, is Executive Vice President of the American Telephone and Telegraph Company. He has been a member of the Exchange Board since 1968 and headed the Special Committee whose report led to the 1972 reorganization of the Exchange's governing structure. Following the conclusion of my remarks, he will offer some further brief comments on the need for this legislation.

We are pleased to have the opportunity to appear at these hearings to express the support of the Board of Directors of the New York Stock Exxchange for S. 3126.

May I say at the outset that we appreciate the concern shown by the entire Committee in this matter of appropriate safeguards for public trading on the nation's stock exchanges—and particularly by Chairman Williams, by the Bill's co-sponsors, Senator Alan Cranston and Senator Bill Brock, and by the entire staff.

When the provision which is now S. 3126 was under consideration as a possible amendment to S. 2519, the Exchange's Board had an opportunity to review it in depth. At that time, the Board took the position that while the proposal did not go as far as the Board would have liked with respect to preserving the securities auction markets, it did represent a fair compromise which merited the Exchange's support. Our position today is the same.

Rather than restate the concerns which we presented in great detail to this Subcommittee in our appearance at hearings on S. 2519 last November,[1] I would like to focus today on the essential public-interest aspects of this issue.

At the heart of S. 3126 is the public policy determination that it is in the vital interests of more than 30 million American investors to preserve the public exchange auction markets in this country.

There is near-universal agreement on this point. Senator Williams stressed it when he introduced the National Securities Market System Act on the Floor of the Senate last October. The hearing record on that Bill is filled with specific affirmations by the SEC and by representatives of the securities industry.

The SEC, in its March, 1973 white paper on the "Structure of a Central Market System," stated "the Commission's commitment to the preservation of an auction-agency market rather than a purely 'dealer market' for listed sceurities." The SEC added, "Perhaps it is worthwhile to state again, unequivocally, that the Commission does not wish to encourage the creation of a purely dealer market for listed securities."[2]

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[1] The Exchange's testimony before the Subcommittee on Securities on November 13, 1973 is included in the hearing record on S. 2519 on pages 165 to 517.

[2] Policy Statement of the Securities and Exchange Commission on the Structure of a Central Market System, page 24.

Treasury Secretary George P. Shultz, as recently as January 29, stressed the close dependence of investor confidence on the maintenance of fair and efficient securities markets.[3]

And the recent Treasury Department Report, "Public Policy for American Capital Markets," in a sense expanded on Secretary Shultz's remarks.[4]

It is perhaps also pertinent to recall here Chairman Williams' succinct statement of the objectives of S. 2519 when he introduced that Bill on the floor of the Senate last October 2.[5]

Mr. Chairman, the texts of the various comments to which I have referred are footnoted for the Subcommittee in my prepared text

In addition, I would note Chairman Williams' comment to the Senate on March 6 when he described S. 3126 as "a major piece of securities legislation which will go a long way toward speeding the development of a central market system and *bolstering investor confidence in the markets.*" (Emphasis added)

The SEC has underscored the fact that the element of public confidence so vital to individual participation in the securities markets is not well-served by dealer markets. Consider this illuminating description of a dealer market from the Commission's March 1973 white paper:

"Presumably, the classic example of a dealer market is the over-the-counter market, in which it is virtually impossible for an investor's order to be executed without the participation of a dealer in the transaction. There is no facility whereby public corders can offset each other, except under the auspices of a market maker, and this rarely occurs. Since the intervention of a dealer involves an additional spread between the prices at which investors can buy and sell, it is likely that in many instances investors obtain less favorable prices on their trades than if they could trade with other investors."

By contrast, the advantages of a public exchange auction market may be demonstrated by describing simply how transactions are handled on a stock exchange.

In an exchange auction market, all public orders are treated fairly—with the first order received at the best price receiving priority over other orders. This is so regardless of whether that order is from an individual investor purchasing 100 shares of stock or from an institution buying 10,000 shares. Moreover—and this is a terribly important point—all public investors can participate in any transaction in the auction market to the extent that they are willing to enter better bids than anyone else or succeed in reaching the market before anyone else.

This, very simply, is the auction which is conducted openly, the results of which are immediately reported to the world via the ticker tape. An investor watching the tape can see that his transaction was completed at a price which was the same as, or related to, other prices which preceded his purchase or sale.

This auction, therefore, combines the elements of fairness, orderliness, full disclosure and equal treatment and is designed to do so in a way that builds individual investor confidence in the market mechanism.

Accordingly, the central issue addressed by the Bill is whether orders of public investors in listed stocks should be exposed to all other orders of public investors in those stocks. This is what happens in a public exchange auction market—regardless of whether the investor happens to be a private citizen of modest

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[3] "The general objective of public policy is to have markets that operate in a fair and efficient way. Fairness and efficiency lead to confidence on the part of the investing public that returns will be reasonably related to risks, that the institutions through which they deal have financial integrity, and that the individual investor is not at a serious disadvantage compared with the institutional investor." Address by Secretary Shultz, United States Saving Bond Campaign Luncheon.

[4] "All evidence suggests that the proportion of Americans investing directly in common stocks and other corporate securities is much greater than the proportion of any other country. The New York Stock Exchange is by far the largest organized capital market in the world, and the other American exchanges and the over-the-counter market are relatively large and active by comparison with most foreign markets. For approximately 50 years, New York has also been the leading center of international finance.

"The characteristics of the American capital markets which have produced these results are numerous, but among the more important are the fact that investors feel that they can buy at the lowest available price and sell at the highest available and the fact that the generation and flow of relevant information is relatively rapid, accurate, and complete." Treasury Department Report, *Public Policy for American Capital Markets*, page 1.

[5] "First, the maintenance of stable and orderly markets with maximum capacity for absorbing trading imbalances without undue price movements. And second, centralization of all buying and selling interests with appropriate protection of public orders. In this way every investor will be assured of receiving the best possible execution of his order, regardless of where it originates."

means or a multi-billion-dollar institution. This does not happen in the over-the-counter dealer market in listed stocks—in the so-called third market.

The primarily institutional third market has little, if any, individual participation. In that market, an institution, typically, will sell listed stock directly to a dealer who, in turn, will sell it to an institutional buyer. Conversely, the third market dealer may buy stock directly from an institution and subsequently sell it either directly and privately to another institution, or publicly on the floor of a stock exchange. All of these transactions between dealers and institutions take place in the privacy of the dealer's office—or, if you will, in secret. This secrecy factor—a characteristic of dealer markets—will continue to prevail even when a consolidated tape becomes operative because disclosure of a trade after it takes place will not change the fact that individual public investors do not have the opportunity to participate in it.

Moreover, dealer markets are in practice less stable than exchange auction markets. When stock prices are rising, dealers can be expected to step up their market-making activities. However, when stock prices are declining, dealers are free to close up shop in those issues since, unlike stock exchange specialists, they have no obligation to maintain orderly markets. As dealers refuse to make markets, stock price instability is intensified and down markets become more severe.

This is substantially what happened during the recent price decline in the dealer-oriented corporate bond market, where market-makers simply turned their backs, reducing the overall amount of capital devoted to market-making and severely damaging liquidity.

Recent studies of the NASDAQ quotation system have shown that this same type of "fair-weather" market-making is common in the present over-the-counter market in both listed and unlisted stocks. It is also demonstrable that dealers generally choose to make markets only in the most active listed stocks, again since they have no obligation comparable to that of exchange specialists also to handle less active issues.

Also, because of the secrecy of third market trading, there is very little publicly available data on the nature and extent of their activities.

Currently, the only publicly available data on third market transactions is based on quarterly reports filed with the SEC, a summary of which is released by the SEC without verification.

These data show, for example, that in the fourth quarter of 1973, total third market trading amounted to 5.4% of the share volume and 6.6% of the dollar volume of all trading on the New York Stock Exchange.

As you know, the Exchange and others have expressed deep concern that the advent of fully competitive commission rates will give broker-dealers compelling reasons of economic self-interest to leave the exchanges and act as over-the-counter dealers in listed stocks. We have repeatedly expressed our great concern that this will trigger an inevitable decline in the quality of the existing exchange auction markets and in the services available to individual investors.

S. 3126 speaks to this concern. The Bill provides, as Senator Williams, Senator Tower and others have said, a "fail-safe" mechanism, by giving the SEC the authority to require that all trades by broker-dealers in listed securities be effected on registered national stock exchanges—if the SEC makes certain findings.

The Bill provides that the Commission "shall" adopt a rule prohibiting broker-dealers from effecting transactions in listed securities other than on a national securities exchange. It has been suggested that the word "may" be substituted for "shall," to give the Commission greater latitude in deciding what action to take. But this would also lead inevitably to a degree of uncertainty that seems inconsistent with the intent of the Bill. It seems clear that the public interest supports the preservation of the exchange auction markets as a matter of national policy. If the SEC should decide, however, that some other way of achieving the objectives of a national market system is feasible. S. 3126 allows for such an alternative by providing in sub-section (3) that the rule imposed by the Commission "shall not remain in effect after the Commission has determined that a national market system for securities has been established."

Accordingly, we prefer the term "shall," which provides for certainty for the near term without undermining the Commission's authority to decide on an alternative approach, should one be developed, in creating a national market system.

Further, S. 3126 does not restrict or eliminate the Commission's authority to take alternative action under various provisions of S. 2519. These would include, for example, regulating dealers, imposing equal rules and regulations in all markets and regulating non-exchange members who bring transactions to the exchanges.

Therefore, the crucial policy question raised by S. 3126 is what, if any, developments should trigger the requirement that all trades in listed securities be effected on the national stock exchanges.

S. 3126 places the burden of triggering the requirement on the Commission. The Commission must find, after notice and opportunity for hearings, that (1) the fairness and orderliness of the exchange markets or the self-regulatory capabilities of the exchanges have been or are likely to be affected in a manner detrimental to the public interest by over-the-counter trading in listed securities; and (2) no rule of any exchange would unreasonably impair the operations of existing third market dealers, which would be integrated into the exchange markets, or unreasonably restrict competition in the exchange markets.

While these triggering provisions seem fair, they are also troublesome. Our Board believes, and has publicly stated on many occasions, that the public interest would be best served by requiring all transactions in listed securities effected by broker-dealers to be exposed to all other such transactions.

The problem with the triggering provisions of the Bill is that they require a determination that the fairness and orderliness of the public auction markets have been—or are likely to be—impaired, in terms of the public interest, *before* the Commission can act. Understandably, we would like to see action taken before the markets are adversely affected.

Ideally, we would like to see the possibility of damage to the auction market mechanism avoided either by having Congress determine *now*, as a matter of policy, that it will not be permitted to occur, or by writing specific triggering conditions into the Bill which will impose the requirement before any damage can be done to our capital markets.

Obviously, these or any comparable remedial approaches would require a public policy determination by this Committee and the Congress.

We recognize, as I stated at the outset, that S. 3126 offers a reasonable compromise solution to the problems we have outlined, and it is for this reason that our Board supports the Bill. We would not, however, want to see S. 3126 weakened in any way. What I am saying is that if revisions are to be made, we would urge that the Bill be strengthened rather than weakened.

Again, on behalf of our entire Board, I want to express our appreciation for the time and attention and thoughtful analysis the Committee and its staff have given and are continuing to give to this issue.

Senator WILLIAMS. Thank you, gentlemen.

We call now Mr. Aaron R. Eshman, Mr. Arthur B. Durkee, Mr. Joseph R. Neuhaus, and Mr. Lawrence S. Black. Are you gentlemen all masters of synthesis? I hope so.

Senator BIDEN. Gentlemen, would you identify yourselves and proceed in any manner in which you can agree upon?

STATEMENT OF AARON R. ESHMAN, STERN, FRANK, MEYER AND FOX, INC.; ARTHUR B. DURKEE, STERNE, AGEE & LEACH, INC.; JOSEPH R. NEUHAUS, UNDERWOOD, NEUHAUS AND CO.; AND LAWRENCE S. BLACK, BLACK AND CO.

Mr. DURKEE. I want to assure you that it was made up some time ago before I heard anybody else's testimony.

Senator BIDEN. There is no way you can anticipate the testimony, of course. I can't even anticipate the answers to the answers. Thank you. Go ahead.

Mr. DURKEE. I am Arthur Durkee and I am executive vice president of Sterne, Agee, and Leach, Inc., of Birmingham, Ala. with branch offices in Montgomery and Mobile, Ala. We are members of the New

York Stock Exchange, associate members of American Stock Exchange, and members of Philadelphia-Baltimore-Washington Exchange.

We are underwriters and distributors of municipal and corporate securities and market makers in certain stocks with markets local to our section. We are a small regional firm.

We strongly favor Senate bill S. 3126 as presented by Senators Williams, Brock, and Cranston and urge its adoption without change or amendment.

The generally accepted conception of a central market system in listed stocks, equally available to all, large and small, seems to us to be wholly inconsistent with the existence of a separate unlisted dealer market in listed stocks. A true central market for listed stocks requires not only that all transactions be publicly reported on a unified tape but also that all orders to buy or sell listed stocks compete with each other as to price and as to supply and demand in the auction market.

If fixed commission rates are abolished as contemplated, and if the third market should expand, it may become difficult for our firm to see how we are justified in retaining membership in stock exchanges. Stock exchange membership entails considerable expense not only by remittance to the exchange, but more important is the time of competent personnel within our organization, supervising compliance rules and regulations prescribed by the exchanges for members, and with preparing reports at frequent intervals and in examinations.

Such necessary adjuncts of exchange memberships are time consuming and expensive and require some of the best talent we have in our organization. If we as nonmembers are free to trade in listed securities either as agent for a commission or as a dealer for our own account, we would have more freedom of action, much less expense, and would not be subject to disciplinary surveillance except as prescribed by NASD and SEC.

We have always actively supported NASD and its rules and regulations which we welcome not only in the public interest but definitely in the interest of reputable dealers and brokers.

Members of our organization have consistently served on committees not only of NASD throughout its existence but also served on the original NRA committee before enactment of the Maloney Act.

We have supported the rules and regulations of the stock exchanges with which we have been affiliated. In 1958, we joined New York Stock Exchange, having for years prior to that time been members of Midwest Stock Exchange and dealers and brokers in both listed and unlisted stocks.

We believe the New York Stock Exchange rules have been in the public interest and it was to our interest to join this exchange giving us, for the benefit of our customers, access to the largest auction market in America, and the benefit of rules and regulations calculated to insure fair prices under equitable trading conditions and fixed minimum commission rates.

If trading in listed securities off an exchange increases, and if all minimum commission rates are abolished, we feel that not only we, but many other brokers, may consider resigning exchange memberships and joining the third market crowd free, to get the benefit of the

knowledge of transactions from the consolidated tape and then buying or selling as appear to be to our own best interest.

This would further fragment the market and make membership in stock exchanges, already in a profit squeeze, less desirable and less profitable.

On behalf of myself and associates of my firm, I express our great appreciation of your giving us the opportunity to state our views for your consideration.

Thank you.

Senator WILLIAMS. Thank you very much, Mr. Durkee. You came here from Birmingham, and is your office there?

Mr. DURKEE. Yes, sir.

Senator WILLIAMS. Now, Mr. Eshman.

Mr. ESHMAN. Thank you very much, Senator. I appreciate the opportunity to appear here. I propose with the chairman's permission to highlight the written testimony submitted and that it be included as part of a permanent record.

Senator WILLIAMS. It will be.

[The complete statement of Mr. Eshman may be found at p. 117.]

Mr. ESHMAN. I am Aaron R. Eshman, and I am president and chief executive officer of Stern, Frank, Meyer & Fox, Inc., a member of the New York, American, and Pacific Stock Exchanges and the Chicago Board Options Exchange. We are headquartered in Los Angeles, Calif., with three branch offices in the Greater Los Angeles area and one office in New York City.

I appear in support of S. 3126 and urge its adoption without any changes which would weaken either its intent or its effect.

Our firm, founded on November 1, 1932, conducts a general brokerage business, with approximately 80 percent of our business being transacted with the public and 20 percent with institutional investors.

I propose in summarizing my testimony to point out the importance of capital formation; that public participation is essential; that public confidence is important to this participation; and that the auction process with self-regulation, competition for, and participation in executions at the best price with fair and equal treatment is important to that confidence.

We have approximately 7,000 retail clients. While many clients utilize our brokerage facilities—as a means of effecting transactions at their initiation, a majority of our other clients rely on us for specific investment guidance. Some of our present clients are the second and third generation of investors utilizing our firm's facilities.

During that period following the onset of negotiated rate and until the central market system is operative, many firms could leave the Nation's exchanges to execute their customer's orders within the confines of their own offices—in the third market—or possibly have the best—or worst—of all worlds, obtain nonmember access to the exchanges for execution without the expense and regulation of membership. Several New York Stock Exchange member firms have already indicated that they may leave the New York Exchange.

During this interim period, all of our clients must be assured complete access for their transactions to a system that provides complete visibility, opportunity for competing for the best price, fair and equal treatment in an atmosphere where self-regulatory rules and procedures

maintain the efficiency of the market, thereby safeguarding their interests.

Chairman Williams has expressed somewhat the same conviction when he said "there are many advantages to the auction market and it should be preserved. These advantages include priority for orders of public investors over those of dealers and the ability of the public orders to meet inside the existing dealer quotation spread."

The overall objective, gentlemen, of the securities industry in the United States is to provide the most efficient and effective mechanism for capital formation and to insure complete liquidity of our securities market. This mechanism has been in being for almost 200 years and is responsible in no small measure for the sensational growth and viability of our free enterprise system. Many great companies would not be where they are today, were it not for the ability of firms such as ours and others throughout the Nation to provide through our clients the ongoing financing necessary to insure their development and growth.

More importantly, corporate America is distressed to the point of anxiety over the state of today's capital markets.

Public confidence in the secondary securities markets is an integral part of the capital formation system. Organized markets with their surveillance, regulation, and the role of the professional sublimated to that of the public are critical in maintaining public confidence. That is why this interim period must safeguard the investor's right to liquidity.

In a recent speech, Lynn Townsend, chairman of the board of Chrysler Corp., has stated, "It is impossible for me to overemphasize the seriousness of the current inability of most companies in this country to raise equity capital. This Nation, in the lifetime of some of us here today, could descend from the relatively self-sufficient industrial power that has been our great strength to one large service industry for the rest of the world, largely dependent on other countries for its basic products."

Thirty million Americans own common stocks. While that number is of interest, what is of even greater significance is that for the first time since records have been maintained during 1972 and 1973, there were 800,000 fewer stockholders.

Individual investors have been leaving the securities markets. Statistics provided me by the New York Stock Exchange indicate that American Telephone & Telegraph had 100,000 fewer shareholders from 1968 to 1973, Pacific Gas & Electric, headquartered in California, has lost over 30,000 shareholders between 1971 and 1973 and Exxon during that same period suffered a loss of more than 50,000 individual shareholders.

We must find ways to bring these and new investors back to the marketplace. We need a larger pool of potential capital contributors to provide the funds for the future growth and development of our Nation's industries. Historically what has been the largest factor in this capital contribution pool has been the average public investor. I point out in my written testimony that Reginald H. Jones in a speech made in January 1974 related that in today's dollars about 3.3 trillion will have to be raised between now and 1985 to meet the needs of the growing industrial community.

He asks rhetorically, "Where will it come from?" In summary the whole capital formation process depends upon liquid markets.

Even the Treasury Department appears uncertain about the consequences following the onset of negotiated rates. In his paper entitled "Public Policy for American Capital Markets," Prof. James H. Lorie concludes the section dealing with this problem by stating, "In summary the SEC's case and the additional arguments presented here do not lead to accepting the New York Stock Exchange's conclusions regarding the harmful consequences to the public of permitting off-board trading of listed securities after April 30, 1975.

At the same time it must be recognized that uncertainties do exist and should the adverse consequences appear, the SEC should promptly impose effective remedies—perhaps through the prohibition which the New York Stock Exchange seeks."

Congress, the SEC, and our industry should not be guilty of risking the dismantling of a delicate mechanism that has taken 200 years to build and is the envy of the entire free world.

No other world securities market inspires the confidence and reflects the liquidity that ours do. While this particular bill will certainly not cure the problem, at least it is a step in the direction of insuring that during the bridge period the SEC will have sufficient authority to take action to prevent fragmentation of our markets.

I wish to thank the subcommittee for this opportunity to express my views on this subject.

Senator WILLIAMS. Thank you, Mr. Eshman.

Mr. Neuhaus?

Mr. NEUHAUS. Thank you, Mr. Chairman.

I would like to summarize my written remarks. (See p. 119).

I am Joseph R. Neuhaus. I have been in the securities business for 28 years. I am chairman of the board and act as chief executive officer of Underwood, Neuhaus & Co., Incorporated of Houston, Tex.

We are investment bankers, security dealers and stockbrokers.

The firm was founded in 1907, is headquartered in Houston and has a branch in Dallas. We are members of the New York, American, Midwest and Chicago Board Options Exchanges. We have 212 employees.

The stock exchange revenues currently account for about 36 percent of our gross income, and of that, about 70 percent would be retail, 30 percent institutional.

We support S. 3126 and urge its passage in substantially its present form.

We do have a comment, however. Before taking action pursuant to this bill, it appears to us the SEC would have to make affirmative findings in both of two areas.

It also appears that the findings in these two areas may conflict and then in such event, it may be desirable to weigh one against the other.

It is possible that developments adversely affecting the public interest and protection of investors may be of such severity as to outweigh adverse effect on third market dealers and that action by the SEC might be desirable in spite of this conflict.

Our reasoning in supporting this bill closely parallels that set forth in the statements on introduced bills and joint resolutions by Senator

Williams, and we are also very much in favor of Senator Williams' comments made in his opening statement yesterday.

Drastic changes are proposed for the securities industry, and the securities exchange community. Ramifications cannot be reliability predicted and may severely damage the availability of corporate equity capital, the investing public, the securities industry, or all of them.

If this happens, it will be important that some Government agency have the power to take prompt remedial action. We believe the SEC is that Agency which can most quickly recognize and best evaluate such situations, and that they should be given the power to take such action.

Passage of this bill appears particularly important to us because we believe it is probable that a need will come to be recognized that all trading in listed securities should be done on an exchange in the auction market.

This market in the past has been held together principally by fixed minimum commissions and the requirement that members bring all orders to the floor of the exchange. The public has realized a further benefit because exchange rules protect the priority of best bid or offer.

We think this benefit will become elusive as more transactions in listed stocks take place on the over-the-counter market.

We concur with those who believe that without new incentives, a number of members will leave the exchanges with the passing of the fixed minimum commission. Our firm will be among those giving serious consideration to dropping one or more of our exchange memberships.

As more members leave the exchange, trading in listed securities will be fragmented and the possibilities of getting the best execution will be decreased. We believe that the most competitive, most efficient, and fairest market is that which can bring all buyers and sellers to a single place where, for example, a broker with an order to buy may show it simultaneously to all brokers or dealers who are sellers.

We believe this can only be done in an auction market and it increases the speed and certainty with which one may find the best available price with minimum chance of missing the market.

Each additional market location that must be checked decreases the speed and certainty of trading at best price and increases the chance of missing the market.

As markets are dispersed, price competition will be reduced and disparity between markets will increase. This can be costly both to the stockholder and his broker.

We, therefore, believe the net effects on the market will be adverse if the third market grows at the expense of the exchange markets which we believe will be the likely result of legislation as presently proposed.

This concludes my comments, Mr. Chairman.

I thank this committee for the opportunity to be here and express the views of our firm.

Senator WILLIAMS. Thank you, Mr. Neuhaus.

Now Mr. Lawrence S. Black.

Mr. BLACK. Thank you.

In order to be brief, I will skip over certain portions of my prepared testimony (see p. 120).

I am Lawrence Black, president and founder of Black & Company, Inc., the only New York Stock Exchange member firm based in Oregon and one of two such firms based in the Pacific Northwest.

I am pleased to have an opportunity to appear before the subcommittee to testify regarding S. 3126. I hope that I can explain how important the bill is to regional member firms such as mine and to their respective customers.

For the most part we are involved in the equity markets. We have a research department specializing in Northwest companies with emphasis on the forest products industry. We are a market maker in a number of regional over-the-counter stocks and we offer a corporate finance capability to our regional companies. About 70 percent of our business is done with individual investors and 30 percent with financial institutions.

Black & Co., was organized in 1959 as a small broker-dealer firm doing business primarily within the State of Oregon. Starting with a membership on the Pacific Coast Stock Exchange in 1962, the firm later became a member of the Midwest Stock Exchange and finally joined the New York Stock Exchange in 1967. Most of my training and experience in the securities business had been with NYSE member firms and from the outset I aspired to have my firm ultimately become a member.

We wanted membership for many reasons. Among them was our belief then and now that the NYSE auction market provides the fairest and most liquid marketplace available to our customers. Additionally, we feel that the stature of the exchange has engendered a necessary degree of confidence among our customers.

During recent years our firm has engaged in the largest volume of corporate financings and underwritings of any Oregon headquartered brokerage firm.

We have participated in financings on behalf of national companies and have acted as manager on behalf of many local companies. Our corporate financing activities have had a positive impact upon the ability of companies based in the Pacific Northwest to raise capital and in providing an essential investment medium for our public customers.

The bill is needed to protect the pricing mechanism of the auction market for public orders.

It is widely argued that off-board trading in listed securities by third marketmakers constitutes an independently viable market for such securities. However, despite its good points, the third market has so far proved itself incapable of independently establishing fair prices for the securities it trades. Trades in the third market are but a mirror image of public trading conducted on the NYSE and reported on the New York Stock Exchange tape. As a member of the exchange, my firm does not ordinarily engage in off-board trading. But within my experience I have noted that, when queried with respect to a particular stock, third marketmakers usually refer to the last sale price on the NYSE.

Commonsense tells us that, the greater portion of trades which are executed in the auction market, the more efficient and fair is likely to

be the pricing mechanism. If the third market continues to draw away from the auction markets, the Commission should use the powers conferred by this bill to confine trading in listed stocks to the registered exchanges.

S. 3126 is required to preserve liquidity for investors.

The exchange specialist system provides a liquidity factor which might not otherwise exist for many relatively inactive stocks. As this subcommittee acknowledged in its 1973 Securities Industry study, not all of the stocks listed on any given exchange are a source of profitable business for the specialist. Nevertheless, each specialist accepts and is required to accept the obligation to maintain a fair and orderly market in those stocks with respect to which he maintains a book.

The specialist's ability to maintain a fair and orderly market in relatively inactive stocks is, to a degree, contingent upon his allocation of some number of those stocks which are considered to be lucrative.

Some would argue that relatively thinly traded securities are not entitled to be the subject of a fair and orderly market. I disagree. Liquidity provided by the specialist system affords a degree of integrity to the market which makes it possible for many of the customers my firm serves to invest in equity securities.

I cannot emphasize enough to this subcommittee the importance to our capital formation process of the expectation of liquidity. It is the need for the liquidity provided by the specialist system which causes corporate issuers to list. This bill provides an element of assurance that liquidity will continue.

S. 3126 will enable the Commission to bridge the gap between implementation of the central market system and equal regulation among marketmakers.

Although it is very stylish these days to talk of the central market system of the future, no one has yet devised a method of apportioning the responsibility of marketmakers within such a system. How is one to decide, for example, who among the exchange specialist and several third marketmakers failed in his obligation to maintain an orderly market during a market break? Questions like this have still not been answered.

For my part, I assume that third market makers are just as ready, willing, and able to accept their share of the responsibility for making fair and orderly markets as are exchange specialists. But the important fact is that there is no established machinery in sight to fairly apportion that responsibility.

It appears that the central market system and particularly the composite reporting aspects of the system will be implemented before a satisfactory method of equal regulation can be devised. This is probably wise. But, it also seems wise to empower the Commission, if the public interest so requires, to confine trading in listed securities to the exchanges until such time as an equitable method of apportioning responsibilities among market makers in diverse regulatory environments is perfected.

The fail-safe feature of S. 3126 is essential to assure that pending reforms in the securities markets will not result in unforeseen and undesirable consequences.

As one who makes his living in the securities industry, I am keenly aware of the reforms which are being proposed by the Commission

and by the Congress. The depth and quality of the analysis which has been conducted by both bodies during the past few years is impressive. The proposed reforms are profound. Many will undoubtedly have a wholesome effect. But the economic dislocations which result from these reforms, though perhaps bearable, will also be profound.

For example, in my State, the 40-percent nonmember discount recently implemented by the New York Stock Exchange is having an impact on the securities business. Some broker-dealers see no reason to tie up capital in exchange memberships when they can avail themselves of most of the benefits of membership without joining.

Development like this, and others which are imminent, pose significant disincentives to my firm retaining its exchange memberships. Other firms much larger than mine have indicated that they can foresee that day when they may have to reconsider the wisdom of maintaining exchange memberships. Should such a movement develop, the damage to the exchange markets could be irreparable.

Again, I appreciate the opportunity to appear and state the views of a regional member firm primarily engaged in servicing individual investors. I shall be pleased to attempt to answer any questions you may have.

Senator WILLIAMS. Mr. Frank Farwell was supposed to be here but was unable, at the last minute, to make it. I have his statement (see p. 169) and there is one point I would like to have your comment on.

He says the need for the dealer function will continue to grow if our markets are to provide the element of liquidity that investors expect.

I believe that the marketmaking capacity of the exchange markets and the third market must both be preserved and fostered as a matter of public policy.

It is my belief and hope that the characteristics of the exchange markets and the third market can and will be melded in the future in such a way as to give the resources presently involved in both markets an opportunity to perform, to grow, and to compete with one another.

Do you have any observations that you would like to make, any comments on his view of the wholesome future? The melding of the markets?

Mr. DURKEE. Well, I will say something. I don't know what he had in mind, really, but our position, for example, in our firm, perhaps a small regional firm is somewhat different from the large New York firm.

I am speaking of our firm. We were opposed to negotiated rates. We like the established rates where everybody knew what they were doing, to try to compete for business and executions and what-not. But we are going to have negotiated rates so if we are going to have negotiated rates we think there should be a central marketplace, otherwise we don't see how we are going to compete.

By staying members of the exchange in the central marketplace we don't know how we will compete. If it is going to be fragmented with other dealers allowed to be allowed to trade off the exchange-listed securities, it is conceivable and possible that commission revenues through the competition and so on would make it unprofitable to stay as members of the exchange whereby we in our particular case could trade possibly some listed securities in our own little third market which we very much prefer not to do.

Senator WILLIAMS. Yes. Anybody else?

Mr. ESHMAN. I don't see anything terribly inconsistent with what Mr. Farwell pointed out, although I don't know exactly what he had in mind there.

I think the bottom line is that there has to be order flow of listed securities to assure the auction process.

There is no reason why this cannot be accomplished. What we are looking at is the bridge period from the time of the onset of negotiated rates until the national or central market system is in being.

All we want to be sure of, is that there is a place where our clients can get the best possible price, can participate in any execution of listed securities.

If a block is going to be traded away, we want to know about it. Our clients want to know about it. And we want an opportunity to participate.

We don't want to find out 20 minutes later that a block was traded in somebody's back office.

I don't see any inconsistencies in what he said.

Senator WILLIAMS. I gather he is saying, and I have not read his full statement, that this bill for the interim period would enable the SEC to meld the two markets and that it would work. They would still be competitive, but still within the same requirements of dealing on the exchanges.

Mr. NEUHAUS. Mr. Chairman, I wonder when he says "meld" and from some of the other terminology whether he does not visualize being subject to the same requirements and if they are subject to the same requirements then it doesn't make it that different from the way I think that Chairman Needham was explaining it.

The problem that we would visualize having is this: that today we can't trade off the exchange in listed securities as a practical matter, and so we look at the New York Stock Exchange as the best market and when we have an order we send it right down to the floor to be executed.

When that broker goes there to buy that stock, he puts his bid in the crowd and if it is the best bid then if there are any takers, he gets it.

There will be different numbers of third market traders active in different stocks, but if we have to first make a decision whether we are going to send it to the floor, we look at the cathode ray tube and see what the other quotes are in the third market, we may then say well, let's try this man in the third market and while we are trying to contact him his line may be busy or he couldn't answer the phone for a few minutes and meanwhile another market is moving and now that one is better, so then we go back to the other O-T-C market or try to get down to the floor because that is the best market now.

You can spend a lot of time running around trying to pin that best market down before you ever get it. As market makers the third market is sort of a shock absorber in the market. They are not the ones creating the supply and demand, but they are helping in a sense to make the market more orderly.

I think that is good, but it is bad for brokers like us to have to have too many places to go to find this best execution.

Senator WILLIAMS. Yes.

Mr. Black?

Mr. BLACK. Mr. Chairman, not to be outdone here, I might be in a somewhat different position than these other firms inasmuch as I founded my firm in 1959 without any exchange membership and I commenced to do business in the third market and for a period of about 5 years that was the source of my being able to trade in listed securities.

I joined the New York Stock Exchange, as I testified, to become more credible, perhaps, and the fact that I was the only firm within my State, and I personally think it would be a step back for my firm with much hesitancy would I resign from the exchange, but yet under economic conditions that would force it I would have no alternative and I would do so with great regret, but I have been through the process of actively trading in the third market and I feel it would be a mistake to return to that status.

Senator WILLIAMS. Earlier you speculated on what you feel the economic impact would be, or will be, with the loss of fixed commission rates and with the third market out there. Did you say that you felt you would possibly leave the exchange in that event and what are the elements that would lead you to that?

Mr. BLACK. I said that I would possibly consider it. I didn't specify the conditions but I would state that it would be primarily economic, it would be a matter of income and net profitability.

We would be returning to a dealer markup system and it is more profitable.

In the years past we found that to be the case. What we would be doing is going back whence we came.

Senator WILLIAMS. Does the disparity of the rules and regulations have anything to do with your thinking that you might leave?

Mr. BLACK. Well, as Mr. Durkee mentioned, we are under the rules and regulations that are quite strict and more severe certainly as a nonmember we are living with those rules. But I believe that those rules are in the best interests of our industry and our customers.

Senator BIDEN. I have one question and I would like each of you to attempt to answer it.

First of all let me again see if I understand what is being said.

Mr. Black indicated that one of the reasons his firm moved to the exchange was the structure of the exchange and the prestige of being a member of that exchange, coupled with the belief in the fairness of the auction market and because most of the trades were conducted there because the fairest price was arrived at on the New York Stock Exchange.

Is that a fair statement of your motivation in moving to the exchange?

Mr. BLACK. That is one of the motivations.

Senator BIDEN. How about telling me what the other ones were if there is anything else?

Mr. BLACK. Well, when I joined the New York Stock Exchange I felt we could expand the scope of our business to the extent of our clientele and expanding on a geographic basis without knowing it was a business judgment.

Senator BIDEN. You didn't feel that the third market had that to offer or else you wouldn't have moved to the exchange; correct?

Mr. BLACK. Well, the nature of our business is such that if we were to have stayed as a broker-dealer executing orders in listed stocks utilizing the third market, we would not have been able to expand to any extent whatsoever.

Senator BIDEN. Then are the reasons for membership by your firm on the exchange, the structure of the exchange, the prestige, and the fairness of the auction market? Are they the primary reasons why you are there?

Maybe we can start at that end and come on down.

Mr. DURKEE. The answer is yes. Also looking back 20 years ago when we joined it gave us access to stocks at what we thought would be the best price in the auction market, over the present third market and enabled us to make commissions, fair commissions that everybody else charged. Also the prestige of it and so on.

But those situations have changed now. Whether we would join the exchange today or not, I am not quite sure. We get 40 percent of the commission from another member for the same execution. If that were the case, I don't know if we were to join or not.

On top of that, if these negotiated commission rates are going to further take care of this and also if there is not going to be a true central marketplace where we are all competing under the same rules in the same areas that is the reason we don't know what is going to happen, what people are going to do with commissions and also to what extent firms are going to charge for other services to make up for the loss of commission revenue if they are going to reduce the commissions under the negotiated rates and whether we can compete in those services or not.

Mr. ESHMAN. Senator, I would launch into a monolog on love of God and country and tell you why I am bullish on the outlook for this industry.

But it revolves around the simple fact that the amount of capital that has to be raised in this country when we get to the bottom line is staggering.

We have heard figures of $3.3 trillion; $4 trillion, it is really academic. We know it is a lot of money. It will come from one of three sources; from the taxpayers; it is going to come institutionally as it is trying to be done in Europe; or it will come the way it has come for the last 200 years, from our industry, the investment banking industry.

Our industry has drawn its strength and vitality from the public. Now, our firm was the first, I believe one of the first of the LA-based firms to join the New York Exchange about 1945 or 1946.

We joined the New York Exchange or the firm joined the exchange at that time for several reasons; one, because it provided access to the auction market; secondly, it provided prestige, it provided a degree of credibility; but more importantly, it provided a degree of regulation.

The public knew exactly what to expect. With all the criticism and all the faults of the national markets, I think that the public has gotten a good deal, the public does know that they are fairly treated. They do know they are meeting one another on that framework.

Senator BIDEN. If I may interrupt, you essentially are saying the same thing. You are concerned about the public, you are concerned about the need to raise the capital in a fair, honest, open way; the way

it's been done; you are concerned about the vitality of this country, and that is one of the reasons why you moved to the exchange.

I don't think that is significantly different from what Mr. Black was saying, don't you agree?

Do you see membership on the exchange as being that vital to the strength of this Nation?

Mr. NEUHAUS. To my mind, there is no question that it has been that way. We joined the exchange about 18 years ago. Previous to that we had joined the Midwest Stock Exchange because that was cheaper to do. We had a New York Stock Exchange member whom we could give New York Stock Exchange business, and they would give us some Midwest Stock Exchange business in return. We thought we could go direct to the Midwest Exchange with an appreciable part of our business.

However we found that we rarely ever went direct to the exchange with an order on a stock dually listed there because we were afraid of missing the market. We knew the primary market was in New York and we wanted our customers to get the best price and, therefore, after a while we found that we were sending all these orders to New York, anyway, so we went and bought the NYSE seat.

Now, in considering whether firms like ours would be likely to give up a seat there is a fact that needs to be considered: that there are a number of stock exchange firms that are not represented on the floor and do not use their seat except to get a preferred commission rate.

We are members of four exchanges but we are represented only on the floor of the New York Exchange. There are many member firms who are not now represented on any exchange. I think it is probable, and in our case it's been so indicated to us, that if they dropped their exchange memberships they could negotiate the same rate that they have now.

Senator BIDEN. Right.

Mr. NEUHAUS. So if we wanted to recover our investment in the seats we could sell those exchange seats. If we found that the rules off the exchange made it more flexible for us than on the exchange, we would evaluate the relative advantages and try to come to a decision.

I couldn't say today that we would leave the exchange. What I can say is we will evaluate it.

What will happen is that we will start by doing business off the board whenever it is advantageous to do so.

Senator BIDEN. Advantageous in terms of the profit picture for your firm?

Mr. NEUHAUS. So long as we didn't sacrifice the price to the customer.

Senator BIDEN. Again, to sum it up, generally you and the rest of the witnesses that have testified from your positions have pointed out that the economic viability of this Nation depends in large part, if not in whole, upon the maintenance of the exchange markets as they now are, particularly the New York Stock Exchange.

You have all further said that it has been the self-imposed rules of that exchange which are needed and essential to protect the public.

You are vitally concerned about protecting the public and that is the only place where that can be done given the present structure of the securities industries.

You have all further said that the more trades that are conducted on a particular market, in this case the New York Stock Exchange, the more likely that the auction function will come into play with a fair price for the customer.

Yet you all turn around, in spite of the fact that you said an exodus from that market to the third market could be, and in some instances some of you have said would be, the demise of our system.

You are saying that a meager little thing like negotiated rates and our profit motive would be such that you would have to consider helping put the country under.

That, to me, is incredible. If it really means that this Nation is going to go under, if you fellows flee, and you would flee because you could get a better rate off the exchange—then, fellows, I either don't think much of your basic argument or I don't think much of you.

Now I know that's strong language. But it makes a young fellow like me skeptical about how strongly you believe that the system will be in demise if in fact there is the exodus.

Maybe you could elaborate on that for me.

Mr. BLACK. Senator, I would like to respond to that. If possible.

One of the words that has not been used has been survival, and I——

Senator BIDEN. I think it has been. I think we talked about the survival of our free enterprise system as it now is structured, and the ability——

Mr. BLACK. I would like to talk about survival of our firm.

Senator BIDEN. I understand that.

Mr. BLACK. That is what we have to consider as to whether we could survive.

Essentially that is an economic function. I think that, sure, you can be idealogical about our overall system, but we are in business and if we choose to stay in this business, we have to survive.

I have been in this my entire business career, so I don't know really what else to do except to go into politics.

Senator BIDEN. It's risky.

Mr. BLACK. But I do take issue with your statement, Senator, as to our not being well-meaning as far as our industry is concerned.

Senator BIDEN. You may very well be well-meaning, but then I have trouble understanding the death knell that you sound for the entire securities industry, the little guy, and our ability to raise capital—how many trillion dollars?

Mr. ESHMAN. $3.3 trillion.

Senator BIDEN. $3.3 trillion, and the Nation's viability, et cetera.

Mr. BLACK. I think those statements were made on what needed to be done, not that they could not be, but they had to be. And how do you best go about accomplishing those.

Senator BIDEN. You all say the best way to go about doing that is guarantee that the exchanges remain viable.

Mr. BLACK. A central auction market is what we are saying.

Senator BIDEN. We are talking about transition to that central market system. We are talking about the interim period and I don't think you gentlemen are suggesting that in that short interim period that some economic hardship may be suffered by you that you would be willing to put the system under.

Mr. BLACK. I think we have had enough economic hardship.

Senator BIDEN. Right.

Mr. ESHMAN. May I respond to your statement, Senator?

Senator BIDEN. Sure.

Mr. ESHMAN. Just very briefly.

It gets my blood flowing, and I've been sitting a long time. I think that we are all trying to accomplish the same end. We are trying to be served in terms of providing jobs and opportunities. It isn't a question of whether we are going to leave the exchange and whether the exchange is the best place for us to do our business.

I think the most important thing is the public, the small investor, the 30 million people out there that are left who still own securities, even though, as I pointed out, American Telephone has lost 100,000 individual shareholders.

I think the public has to have a degree of confidence and I don't know that your statement is exactly true that we would all leave the exchange because we could make a buck maybe better somewhere else.

Senator BIDEN. I don't think you would leave the exchange.

Mr. ESHMAN. No, I think we are going to do what is best for our clients and for our business. We all have capital at risk, and we are delighted to have it at risk, because we think we can make money on our capital and provide a useful service.

I think Congress has a responsibility, I think the SEC has a responsibility, and I think the industry has a responsibility to see to it that our capital markets remain viable because if the capital markets of the United States do not remain viable, we have a lot of other questions to address ourselves to.

It really isn't a question of when the central marketplace will be in place, what will happen until then. I don't know when it will be and I don't know that anyone in this room does. I don't know what it will cost or who will pay for it.

Senator BIDEN. The only way it remains viable is that if the exchanges remain viable.

Mr. ESHMAN. If the auction process remains viable.

Senator BIDEN. And all we have now is the exchanges, right?

Mr. ESHMAN. At the present time, the national exchanges are the best example of the auction process. If we had equal regulation, the whole question would probably be academic at the moment.

Senator BIDEN. Thank you very much, gentlemen.

Mr. DURKEE. I don't think the country is going under either.

Senator BIDEN. Neither do I; that is why I worry about the doomsday predictions if in fact we go to negotiated rates. That is why I raised it.

Senator WILLIAMS. You know, it's taken us a long time to deal with that meager little question of negotiated rates. How many years has this been in evolution, trying to get to the point where the Chairman of the SEC has announced the demise of fixed rates? It's been a long time.

So it might have been meager, Joe, but it's been a long, hard time.

Senator BIDEN. I compliment you on that long, hard point. That is the whole point.

But you fellows are saying because we are going to negotiated rates and because there is no protection to force everybody on the exchange in the interim, you know, the bottom is going to fall out.

Mr. ESHMAN. We say it is possible, and the SEC says it is possible, and the Treasury says it is possible. Everybody says it is possible, and all we are trying to do is buy a little insurance, which costs nothing.

We don't want to be half pregnant, we want to be all pregnant.

Senator BIDEN. I think we are pregnant. I am not sure who the father is, though. Thank you.

[The statements of the preceding witnesses follow:]

STATEMENT OF ARTHUR B. DURKEE, EXECUTIVE VICE PRESIDENT, STERNE, AGEE & LEACH, INC., BIRMINGHAM, ALA.

My name is Arthur B. Durkee. I am Executive Vice President of Sterne, Agee & Leach, Inc. of Birmingham, Alabama, with branch offices in Montgomery and Mobile, Alabama. We are members of New York Stock Exchange, Associate Members of American Stock Exchange, and members of Philadelphia-Baltimore-Washington Exchange. We are underwriters and distributors of municipal and corporate securities and market makers in certain stocks with markets local to our section. We are a small regional firm.

We strongly favor Senate Bill S. 3126 as presented by Senators Williams, Brock and Cranston and urge its adoption without change or amendment.

The generally accepted conception of a central market system in listed stocks, equally available to all, large and small, seems to us to be wholly inconsistent with the existence of a separate unlisted dealer market in listed stocks. A true central market for listed stocks requires not only that all transactions be publicly reported on a unified tape but also that all orders to buy or sell listed stocks compete with each other as to price and as to supply and demand in the auction market.

A third market dealer has the advantage of current reports on all transactions in the auction market and then may buy or sell for his own account when it is to his advantage to do so. Such dealer in listed stocks may buy or sell or decline to do so. Although his executions may be generally good, there is no assurance that the investor receives the most favorable price available in the market at that time. Such dealer may protect himself, but there is no way to assure the investor that he is receiving the most favorable price available.

On listed securities, we believe the public interest is best served by an auction market where all orders in listed stocks are executed in competition.

Fragmentation in the market in listed securities by the existence of separate dealer markets is wholly inconsistent with the conception of a central market and deprives the public of the benefit of true competitive prices to the extent that purchases and sales are consummated by the dealer and withheld aside and apart from the competitive auction market.

If fixed commission rates are abolished as contemplated, and if the third market should expand, it may become difficult for our firm to see how we are justified in retaining membership in stock exchanges. Stock exchange membership entails considerable expense not only by remittances to the exchange, but more important is the time of competent personnel within our organization, supervising compliance rules and regulations prescribed by the exchanges for members, and with preparing reports at frequent intervals and in examinations. Such necessary adjuncts of exchange memberships are time consuming and expensive and require some of the best talent we have in our organization. If we, as nonmembers, are free to trade in listed securities either as agent for a commission or as a dealer for our own account, we would have more freedom of action, much less expense and would not be subject to disciplinary surveillance except as prescribed by NASD and SEC.

We have always actively supported NASD and its rules and regulations which we welcome not only in the public interest but definitely in the interest of reputable dealers and brokers.

Members of our organization have consistently served on committees not only of NASD throughout its existence but also served on the original NRA committee before enactment of the Maloney Act.

We have consistently supported the rules and regulations of the stock exchanges with which we have been affiliated. In 1958, we joned New York Stock Exchange, having for years prior to that time been members of Midwest Stock Exchange and dealers and brokers in both listed and unlisted stocks. We believe the New York Stock Exchange rules have been in the public interest and it

was to our interest to join this exchange giving us, for the benefit of our customers, access to the largest auction market in America, and the benefit of rules and regulations calculated to insure fair prices under equitable trading conditions and fixed minimum commission rates. If trading in listed securities off an exchange increases, and if all minimum commission rates are abolished, we feel that not only we, but many other brokers, may consider resigning exchange memberships and joining the third market crowd free, to get the benefit of the knowledge of transactions from the consolidated tape and then buying or selling as appear to be to our own best interest. This would further fragment the market and make membership in stock exchanges, already in a profit squeeze, less desirable and less profitable.

On behalf of myself and associates of my firm, I express our great appreciation of your giving us the opportunity to state our views for your consideration.

STATEMENT BY AARON R. ESHMAN, PRESIDENT, STERN, FRANK, MEYER & FOX, INC.

My name is Aaron R. Eshman. I am President and Chief Executive Officer of Stern, Frank, Meyer & Fox, Incorporated, a member of the New York, American and the Pacific Stock Exchanges, and of the Chicago Board Option Exchange. We are headquartered in Los Angeles, California, with three branch offices in the greater Los Angeles area and one office in New York City.

I appear in support of S. 3126 and urge its adoption without any changes which would weaken either its intent of effect.

Our firm, which was founded on November 1, 1932, conducts a general brokerage business, with approximately 80% of our business being transacted with the public and 20% with institutional investors. We market research, based upon our close association with a number of companies and their managements headquartered in California, to institutional investors throughout the United States and Europe. In addition to our general brokerage business, we are dealers in the stocks of approximately forty companies located in Southern California which trade in the Over-the-Counter Market and maintain primary markets in approximately fifty small banks headquartered in Southern California. We have approximately seven thousand retail clients. While many clients utilize our brokerage facilities as a means of effecting transactions at their initiation, a majority of our other clients rely on us for specific investment guidance. Some of our present clients are the second and third generation of investors utilizing our firm's facilities.

While I support S. 3126, I would like to go on record as stating that any alteration of the language which would weaken the underlying intent should be rejected. S. 3126 is designed as a "fail safe" mechanism to provide a means of insuring liquidity in our capital markets during that period from the onset of fully negotiated rates until the Central Market System is operative. In effect, the SEC would be empowered with authority to prevent dismantling of our capital markets.

During that period following the onset of negotiated rates and until the Central Market System is operative, many firms could leave the nation's Exchanges to execute their customers' orders within the confines of their own offices—in the Third Market—or possibly have the best (or worst) of all worlds, obtain nonmember access to the exchanges for execution without the expense and regulation of membership. Several New York Stock Exchange member firms have already indicated that they may leave the New York Exchange.

During this interim period, all of our clients must be assured complete access for their transactions to a system that provides complete visibility, opportunity for competing for the best price, fair and equal treatment in an atmosphere where self-regulatory rules and procedures maintain the efficiency of the market, thereby safeguarding their interests. Such a system can only be found through the auction process.

The auction process assures competition for best prices at the least cost. Public confidence and trust in our capital markets can not be violated. James J. Needham, Chairman of the New York Stock Exchange, in his testimony before the Senate Subcommittee on Securities on S. 2519, correctly stated, "there is no effective way that hundreds of dealers operating in the privacy of their own offices around the country can be regulated—and their activities continuously monitored and surveyed—as is possible in an open, public exchange market with almost instantaneous public disclosure of all transactions."

Chairman Williams has expressed somewhat the same conviction when he said, "there are many advantages to the auction market and it should be preserved. These advantages include priority for orders of public investors over those of dealers and the ability of the public orders to meet inside the existing dealer quotation spread."

The overall objective of the securities industry in the United States is to provide the most efficient and effective mechanism for capital formation and to insure complete liquidity of our securities markets. This mechanism has been in being for almost two hundred years and is responsible in no small measure for the sensational growth and viability of our free enterprise system. Many great companies today would not be where they are, were it not for the ability of firms such as ours to provide through our clients the on-going financing necessary to insure their development and growth. More importantly, corporate America is distressed to the point of anxiety over the state of today's capital markets.

Public confidence in the secondary securities markets is an integral part of the capital formation system. Organized markets with their surveillance, regulation, and the role of the professional sublimated to that of the public are critical in maintaining public confidence. That is why this interim period must safeguard the investor's right to liquidity.

Lynn Townsend, Chairman of the Board of Chrysler Corporation, has stated, "It is impossible for me to overemphasize the seriousness of the current inability of most companies in this country to raise equity capital. This nation, in the lifetime of some of us here today, could descend from the relatively self-sufficient industrial power that has been our great strength to one large service industry for the rest of the world, largely dependent on other countries for its basic products. I firmly believe that there will be serious adverse consequences if our capital markets are not able to supply to corporate America the equity capital that it needs at prices that are acceptable. Not only will the management and owners of these corporations be damaged, but their employees, their suppliers and the public at large will be damaged as well."

Thirty million Americans own common stocks. While that number is of interest, what is of even greater significance is that for the first time since records have been maintained, during 1972 and into 1973, there were eight hundred thousand fewer stockholders. Individual investors have been leaving the securities markets. Statistics provided me by the New York Stock Exchange indicate that American Telephone and Telegraph had 3.142 million individual stockholders in 1968, and at the end of 1973 that number had dropped to 2.934 million, reducing their shareholder population by over 100,000. A company in California, Pacific Gas & Electric, has lost over 30,000 stockholders between 1971 and 1973, and Exxon, during that same period suffered a loss of more than 50,000 shareholders. We must find ways to bring these and new investors back to the market place. We need a larger pool of potential capital contributors to provide the funds for the future growth and development of our nation's industries. Historically what has been the largest factor in this capital contribution pool has been the average public investor. Reginald H. Jones, Chairman of the General Electric Company, in his speech of January 24, 1974, related that their economists, admitting their own fallibility in the fast changing scene, estimates that the cumulative capital investment needs of the United States between now and 1985, in today's dollars, will be on the order of $3.3 trillion. Jones states, "most of that will have to be raised and invested by the business community. Where will it all come from?" Incidentally, I am certain General Electric is not including the capital demands of local and state governments. In summary, the whole capital formation process depends upon liquid markets.

Even the Treasury Department appears uncertain about the consequences following the onset of negotiated rates. In his paper entitled *Public Policy For American Capital Markets*, Professor James H. Lorie concludes the section dealing with this problem by stating, "In summary, the SEC's case and the additional arguments presented here do not lead to accepting the New York Stock Exchange's conclusions regarding the harmful consequences to the public of permitting off-board trading of listed securities after April 30, 1975. At the same time it must be recognized that uncertainties do exist and should the adveres consequences appear, the SEC should promptly impose effective remedies—perhaps through the prohibition which the New York Stock Exchange seeks."

Congress, the SEC, and our industry should not be guilty of risking the dismantling of a delicate mechanism that has taken two hundred years to build and is the envy of the entire free world. No other world securities market inspires

the confidence and reflects the liquidity that ours do. While this particular bill will certainly not cure the problem, at least it is a step in the direction of insuring that during the bridge period the SEC will have sufficient authority to take action to prevent fragmentation of our markets.

I wish to thank the Subcommittee for this opportunity to express my views on this subject.

STATEMENT OF JOSEPH R. NEUHAUS, CHAIRMAN OF THE BOARD OF UNDERWOOD, NEUHAUS & CO., INC., OF HOUSTON, TEX.

I am Chairman of the Board and act as chief executive officer of Underwood, Neuhaus & Co., Incorporated. We are investment brokers, security dealers, and stockbrokers. The firm was founded in 1907, is headquartered in Houston and has a branch in Dallas. We are members of the New York, American, Midwest, and Chicago Board Option Exchanges. We have 212 employees, of whom 65–70 are registered representatives who concentrate on client business. In addition, we have 10 professionals operating in the areas of corporate finance, municipal finance and real estate, 5 security traders, and 5 research analysts.

Our Municipal Bond Department is financial adviser to many Texas municipalities, and we are a leading managing municipal underwriter in the State of Texas. We are also one of the largest dealers in Federal Agency Securities in the South and Southwest.

Stock Exchange revenues have accounted for 36.4% of our gross income during the first seven months of our current fiscal year, through February. Of this amount, about 70% was what we call retail business, and 30% institutional. We are also active in the over-the-counter business, both in commission business and in market making. We are normally very active in corporate underwriting, although this business has been reduced in recent months.

Two officers of our firm are on the Board of Governors of the Securities Industry Association, and officers also sit on the Boards of Governors of the National Association of Securities Dealers and the National Security Traders Association.

We support S. 3126 and urge its passage in substantially its present form.

Before taking action pursuant to this bill it appears that the SEC would have to make affirmative findings in both of two areas to be covered in a hearing. It also appears that the findings in the two areas may conflict, and that in such event it may be desirable to weigh one against the other. It is possible that developments adversely affecting the public interest and the protection of investors may be of such severity as to outweigh adverse effects on third market dealers, and that action by the SEC might be desirable in spite of this conflict.

Our reasoning closely parallels that set forth in the "Statements on Introduced Bills and Joint Resolutions," by Senator Williams. Bills presently before both houses of Congress are designed to bring about drastic changes in the securities industry and the securities exchange commodity. The proponents of these bills believe that the changes will be constructive changes. The ramifications, however, cannot be reliably predicted and it is possible that in some areas they may severely damage the availability of corporate equity capital, the investing public, the securities industry, or all of them. If this happens it will be extremely important that some government agency have the power to take prompt remedial action. We believe the SEC is that agency which can most quickly recognize and best evaluate such situations, and that they should be given the power to take such action as they conclude is needed. In view of the magnitude of the changes proposed, can anyone be so certain of achieving the intended results as to waive the capability for timely remedies for unforeseen adversities?

Passage of this bill appears particularly important to us because we believe it is probable that a need *will* come to be recognized that all trading in listed securities *should* be traded on the exchanges. We believe the auction market has proven to be the best and fairest market for stocks with large numbers of stockholders and a large floating supply. This market in the past has been held together principally by fixed minimum commissions and the requirement that members bring all orders to the floor of the exchange. The public has realized a further benefit because exchange rules protected the priority of best bid or offer. This benefit may well become elusive as more transactions in listed stocks take place on the over-the-counter market. We concur with

those who believe that a number of members will leave the exchanges with the passing of the fixed minimum commission. Our firm will be among those giving serious consideration to dropping one or more of our exchange memberships unless new incentives develop. As more members leave the exchange, trading in listed securities will become increasingly fragmented and the possibilities of getting the best available execution will decrease. This may also happen if there is no rule (such as NYSE Rule 394) governing members trading off-board in listed securities.

We strongly believe that the most competitive, most efficient and fairest market is that which can bring all buyers and sellers to a single place, where, for example, a broker with an order to buy may show it simultaneously to all brokers or dealers who are sellers. This increases the speed and certainty with which one may find the best available price, with minimum chance of missing the market. Each additional location that must be checked decreases the speed and certainty of trading at best price, and increases the chance of missing the market. Price competition will be reduced and disparity between markets will increase. This can be costly both to the stockholder and his broker. We, therefore, believe the net effects on the market will be adverse if the third market grows at the expense of the exchange markets which we believe will be the likely result of presently proposed legislation.

That concludes my comments and I thank this committee for the opportunity to be here and express our views.

STATEMENT OF LAWRENCE S. BLACK, PRESIDENT, BLACK & CO., INC.

My name is Lawrence S. Black and I am President and founder of Black & Company, Inc., the only New York Stock Exchange member firm based in Oregon and one of two such firms based in the Pacific Northwest.

I am pleased to have an opportunity to appear before the Subcommittee to testify regarding S. 3126. I hope that I can explain how important the bill is to regional member firms such as mine and to their respective customers.

Because there has been so much talk during recent years about the American system of mobilizing risk capital and about small investors, I would like to take a moment to describe the kinds of business done by my firm and the kinds of customers we serve.

For the most part we are involved in the equity markets. We have a research department specializing in Northwest companies with emphasis on the forest products industry. We are a market maker in a number of regional over-the-counter stocks and we offer a corporate finance capability to our regional companies. About 70 percent of our business is done with individual investors and 30 percent with financial institutions.

Black & Company was organized in 1959 as a small broker-dealer firm doing business primarily within the state of Oregon. Starting with a membership on the Pacfic Coast Stock Exchange in 1962, the firm later became a member of the Midwest Stock Exchange and finally joined the New York Stock Exchange in 1967. Most of my training and experience in the securities business had been with NYSE member organizations, and from the outset I aspired to have my firm ultimately become a member. We wanted membership for many reasons. Among them was our belief then and now that the NYSE auction market provides the fairest and most liquid marketplace available to our customers. Additionally, we feel that the stature of the Exchange has engendered a necessary degree of confidence among our customers.

During recent years our firm has engaged in the largest volume of corporate financings and underwritings of any Oregon headquartered brokerage firm. We have participated in financings on behalf of national companies and have acted as manager on behalf of many local companies. Our corporate financing activities have had a positive impact upon the ability of companies based in the Pacific Northwest to raise capital and in providing an essential investment medium for our public customers. We are part of the American capital formation system. Our ability to act in this capacity depends upon the continued integrity of the trading markets.

While in my opinion trading in listed stocks should be confined to the registered national securities exchanges, I view S. 3126 as a minimum requirement for maintaining the soundness of our auction markets. In my opinion the amendment proposed by Senator Tower should not be adopted as it would impose unnecessary restraints upon the Commission's ability to meet the regulatory needs outlined in the bill in its present form.

I would like to confine the balance of my remarks to a statement of those reasons which suggest most strongly to me the enactment of this important legislation.

The bill is needed to protect the pricing mechanism of the auction market for public orders.

The auction market has been and is the fairest and most efficient method in existence for pricing equity securities. Observation of third market and institutional block trading patterns confirms the validity of the auction market pricing mechanism as it has existed for so long on the exchanges.

It is widely argued that off-board trading in listed securities by third market makers constitutes an independently viable market for such securities. However, despite its good points, the third market has so far proved itself incapable of independently establishing fair prices for the securities it trades. Trades in the third market are but a mirror image of public trading conducted on the NYSE and reported on the New York Stock Exchange tape. As a member of the Exchange, my firm does not ordinarily engage in off-board trading. But, within my experience I have noted that, when queried with respect to a particular stock, third market makers usually refer to the last sale price on the NYSE.

Similarly, block transactions, though usually conducted at a premium or discount from the last sale price, invariably use the public segment of the market as a point of reference in fixing price.

The dependence of institutional and third market trading on the prices established by the public market makes it clear that both the relatively unsophisticated and the seasoned professionals look to the NYSE's auction process as the most reliable index of the price at which a stock should trade.

Despite this fact, however, the coexistence of third market trading in listed securties serves only to detract from the validity of the auction market pricing mechanisms. Common sense tells us that, the greater portion of trades which are executed in the auction market, the more efficient and fair is likely to be the pricing mechanism. If the third market continues to draw away from the auction markets, the Commission should use the powers conferred by this bill to confine trading in listed stocks to the registered exchanges.

These are very practical considerations and I think that the conclusions they suggest are obvious. Professional and public investors alike depend upon the auction market to fix a point of reference for determining the price applicable to securities transactions. The validity and fairness of the auction market increase in direct proportion to the percentage of listed business executed on the exchanges. Conversely, the coexistence of the third market, whatever its virtues may otherwise be, serves to detract from the efficiency and fairness of the auction market.

S.3126 is required to preserve liquidity for investors.

The Exchange specialist system provides a liquidity factor which might not otherwise exist for many relatively inactive stocks. As this Subcommittee acknowledged in its 1973 Securities Industry Study, not all of the stocks listed on any given exchange are a source of profitable business for the specialist. Nevertheless, each specialist accepts and is required to accept the obligation to maintain a fair and orderly market in those stocks with respect to which he maintains a book. The specialist's ability to maintain a fair and orderly market in relatively inactive stocks is, to a degree, contingent upon his allocation of some number of those stocks which are considered to be lucrative.

However, as Mr. Needham, Chairman of the NYSE, has so forcefully pointed out, different conditions prevail in the third market. The tendency among third market makers quite naturally is to make markets in only those securities which are the most lucrative. This "skimming" of the lucrative business from the specialist detracts from his economic incentive and ability to make fair and orderly markets in all of the securities assigned to him.

Some would argue that relatvely thinly traded securities are not entitled to be the subject of a "fair and orderly market." I disagree. Liquidity provided by the specialist system affords a degree of integrity to the market which makes it possible for many of the customers my firm serves to invest in equity securities. I cannot emphasize enough to this Subcommitee the importance to our capital formation process of the expectation of liquidity. It is the need for the liquidity provided by the specialist system which causes corporate issuers to list. This bill provides an element of assurance that liquidity will continue.

S. 3126 will enable the Commission to bridge the gap between implementation of the central market system and equal regulation among market makers.

The stock exchange specialist is required to maintain a fair and orderly market in the securities assigned to him. He must commit his capital to buy at times of over supply and sell in times of scarcity. The third market maker is not subject to such obligations. To be sure the NASD is making significant improvements in defining the obligations of over-the-counter market makers. These improvements will help provide better markets for unlisted securities. But no one would seriously compare the legal obligation of the stock exchange specialist at the present time with that of the third market maker.

Although it is very stylish these days to talk of the central market system of the future, no one has yet devised a method of apportioning the responsibility of market makers within such a system. How is one to decide, for example, who among the exchange specialist and several third market makers failed in his obligation to maintain an orderly market during a market break? Questions like this have still not been answered.

For my part, I assume that third market makers are just as ready, willing, and able to accept their share of the responsibility for making fair and orderly markets as are exchange specialists. But the important fact is that there is no established machinery in sight to fairly apportion that responsibility. It appears that the central market system and particularly the composite reporting aspects of that system will be implemented before a satisfactory method of equal regulation can be devised. This is probably wise. But, it also seems wise to empower the Commission, if the public interest so requires, to confine trading in listed securities to the exchanges until such time as an equitable method of apportioning responsibilities among market makers in diverse regulatory environments is perfected.

The "fail safe" feature of S. 3126 is essential to assure that pending reforms in the securities markets will not result in unforeseen and undesirable consequences.

As I indicated in my opening remarks, I believe that trading in listed securities should be confined to the exchanges. But, regardless of one's position on that question, prudence dictates that some precautions be taken to assure continuity as the securities industry undergoes a period of major change.

As one who makes his living in the securities industry, I am keenly aware of the reforms which are being proposed by the Commission and by the Congress. The depth and quality of the analysis which has been conducted by both bodies during the past few years is impressive. The preposed reforms are profound. Many will undoubtedly have a wholesome effect. But, the economic dislocations which result from these reforms, though perhaps bearable, will also be profound.

For example, in my state, the 40 percent nonmember discount recently implemented by the New York Stock Exchange is having an impact on the securities business. Some broker-dealers see no reason to tie up capital in exchange memberships when they can avail themselves of most of the benefits of membership without joining.

Developments like this, and others which are imminent, pose significant disincentives to my firm retaining its exchange memberships. Other firms much larger than mine have indicated that they can foresee that day when they may have to reconsider the wisdom of maintaining exchange memberships. Should such a movement develop, the damage to the exchange markets could be irreparable.

If this Subcommittee believes as I do that the public auction market provided by the New York Stock Exchange and the other national securities exchanges is the fairest, most liquid and most efficient market in which individual investors can buy and sell equity securities, it is imperative that S. 3126 be enacted by the Congress. Hopefully the powers which S. 3126 would confer upon the Commission will never have to be used. Hopefully the public auction markets will not be imperiled. However, the exchange markets are too central to the American capital formation system and are too great a national asset to be subjected to severe economic dislocation without the creation of a "fail safe" device of the kind provided by this legislation.

Again, I appreciate the opportunity to appear and state the views of a regional member firm primarily engaged in servicing individual investors.

Senator WILLIAMS. Thank you very much.

Mr. Wilcox, Mr. Klann, and Mr. Clark?

STATEMENT OF STEPHEN R. WILCOX, CONNING & CO., INC., ACCOMPANIED BY DAVID H. KLANN, LOEWI & CO., INC., AND FOR RESTER A. CLARK, H. C. WAINWRIGHT & CO.

Mr. KLANN. You are being patient and spending a lot of time on this, and I and the others appreciate this.

My name is David H. Klann, I am a senior vice president and director of Loewi & Co., Inc., a regional investment banking and broker-dealer firm headquartered in Milwaukee, Wis.

I would like my full statement inserted and I will summarize.

Senator WILLIAMS. Fine, and if the rest of you will approach it the same way, fine (see p. 131).

Mr. KLANN. I am appearing in support of this bill, S. 3126. This is a means of assuring our small individual customers that if a mortal danger comes to this industry, that the "insurance policy" that Mr. Eshman talks about will be available.

We are a regional firm in Milwaukee; we have done a lot of investment banking over the years for a lot of corporations that have grown large, listed, and unlisted.

They have added many jobs in the Midwest. A thumbnail capsule of our firm, if you will: our revenues were $13 million last year, virtually all from individuals and small institutions. We are members of the New York, American, Midwest, PBW, CBOE, and Chicago Mercantile Exchanges. We have 35 retail offices out in the Midwest, and about 150 representatives; about 480 employees in total. We have about 160 owners—we're not publicly held, although it seems that way—we have about 160 employee shareholders.

We have a lot of public customers out there.

We're not afraid of change. I think that is true of most regional firms, certainly the leading ones. We are adopting new lifestyes and new attitudes and new ways of doing business. But these simultaneous, multiple changes are concerning us because the convergence of all of them at one time may in fact pose some short-term dislocations which would affect us and our customers.

I would like to highlight now some of my major points. On page 3, I point out that a regional firm such as ours, in dealing with these many individuals out in the Midwest, has to be able to compete fairly and fully in pricing of our services.

Now, the free flow of the buy and sell orders will set the price of the security. Then our firm can put an additional price on the value of our services, over and above that price. We are concerned about the possibility of comingling the price of the security and the price of our service, because it will put our customers at a very servere disadvantage in identifying what is the value, in fact, they are receiving—what are they paying for services vis-a-vis what they are getting.

So that potential compingling confrontation with other firms does exist, particularly against large firms if they are able to leave the auction marketplace with their orders.

A second point I have on page 3, is the basic attribute of the third market, and Senator Biden, this addresses itself to the question you asked (i.e. "define an auction market"). I do believe an auction market

in addition to other characteristics, is also a specific physical location. All interested buyers and sellers converge on this physical, well-defined location.

We can't view the auction market in abstraction. There are many undefinable characteristics. The number of people . . . the noise level . . . the activity . . . I'm sure if you have not been on the New York Exchange, or the even more interesting phenomenon if the Mercantile Exchange in Chicago, they are busy, active places.

But here is where all these orders converge, and, in fact, that marketplace atmosphere can't exist if some of these orders are spread out upstairs to the individual dealer markets.

Dispersion fragments that auction market. It detracts from the nature of the marketplace. Exposure and execution of all orders, large and small in the environment and pressures of this open marketplace will assure our customers, individuals and small institutions, that they are neither at an advantage or disadvantage in their ability to buy or sell a stock.

That is really what they are after. They just want equal opportunity. The small investor, frankly, has little confidence in any activities taken on his behalf in something less than openness. Something less than freedom of participation.

They don't understand listed stock prices negotiated up there in dealers' offices. The regional firms, we think, have a unique advantage because they take advantage of this open marketplace—this open auction market—to give the small investor and the small institution the optimum opportunity for equal treatment in buying and selling, through the auction market.

A third point I have is on page 5; the potential danger which exists in equating the auction market with the dealer or the negotiated market. They are not the same. They never can be the same. You can have a lot of dealers in a negotiated market and it's still not an auction market.

The dealer market offers selected clients, a potential opportunity to avoid or subvert the current market price. An auction market arena on the other hand puts all forces of supply and demand against each other, openly and equally.

The price, then, at any moment becomes the focal point of a very full competitive auction place. The individual and the small institution trusts this marketplace. That is critical. At stake is the ability of the individual or public customer to participate equally.

The auction market, the open auction market dispels the bulk of that. I have referred to these public customers of ours. Let me make some specific observations.

We are not competing with the Merills and the Baches in most cases. We have 35 branches in 31 communities. I detail this on page 6.

In 21 communities our customers are served only by regional firms; almost half, 43 percent of our representatives are serving customers which are not served by national firms.

That is a very close personal relationship. It's not simply the other end of a Watts phone line. The communications are not limited to the telephone call. Very frequently our representatives have to have lunch with their clients. They see them at church, PTA meetings, they have to live with their decisions.

Our brokers and associates are part of the same community life. Our corporate clients have the same relationship. We see these people and we have to live with the decisions we make with them.

The interests and needs of these customers that we're talking about have to be met. If any broker dealer or our firm should find itself in less than a competitive auction market, then our ability, our operational capabilities, our capital, our determination to offer the best service to our clients, is going to be dissipated.

Therefore, I am strongly recommending that you adopt this bill in it's original form without amendments; it will protect these customers that we're also concerned about.

Thank you for this time.

Senator WILLIAMS. Thank you very much.

Mr. Wilcox?

Mr. WILCOX. Mr. Clark will go.

Senator WILLIAMS. Mr. Clark?

Mr. CLARK. I am Forrester A. Clark, a senior partner of H. C. Wainwright & Co., an investment banking firm which was originated in Boston over 100 years ago.

We are members of the New York, American, Midwest, and Boston Stock Exchanges and an associate member of the PBW Stock Exchange.

In connection with our securities brokerage business our firm has established a reputation for providing a high quality of investment research for our customers, and we have maintained a large staff of professional investment analysts to support that service.

I, along with many securities firms in Boston and throughout the country, strongly support S. 3126 as necessary to preserve the effective auction market system which exists in the national securities exchanges of this country.

As my written statement is repetitious of remarks made by other witnesses, I would like to make a few oral observations.

Over the years I have enjoyed and participated in competitive athletics; and in playing football, if you don't play under the same rules and one team is allowed to run 10 yards in from the sidelines and not be tackled, it is pretty difficult to win a ball game. My point is that in this business everybody should play under the same rules.

I read the report, Senator, which you made yesterday, and I agree with you. You have taken most of my speech where you stated you felt the rules were not the same.

I would like to give you an example which resulted in competition for my firm, and I think you will agree with me that it is not playing under the same rules.

When William McC. Martin was asked to make recommendations to improve the operations of the New York Stock Exchange, he visited the chairman of the board of the firm of Dean Witter & Co. in California. During his visit, Dean Witter received an order to sell 50,000 shares of a stock, which at that time was quoted on the NYSE at 80–81. In endeavoring to execute this order, 5,000 shares were sold between 80 and 80½, when suddenly the order was taken away from Dean Witter.

Mr. Martin, remembering what I had told him several weeks prior concerning a similar situation, ask to be informed as to what had

happened to the balance of this order. He was later told that the balance of the order of 45,000 shares was executed in the third market at a price of 77. Mr. Martin took the trouble to check with the New York, Midwest, and Pacific Coast Exchanges where this particular stock is listed. He discovered that 16,000 shares of stock on the books of the specialists in these three exchanges were bypassed at prices between 77 and 80.

For the next 5 days, this stock was still quoted 80–81, and as the price of 77 was not recorded, this third market firm had 5 days to distribute all or part of the 45,000 shares which they had purchased under the umbrella of the NYSE quote of 80–81.

In contrast to the method used by the third market where it makes a commitment as a dealer to purchase a block of stock, my firm has adopted the policy of acting as an agent by selling the stock on a commission basis on an exchange. The reason for our taking this position is that we give our research material to institutional and individual customers all over this country and Europe. If the information is such that our client decides to sell a certain security, it would make very little sense for us to buy that security from him. Likewise, if our information is such that our client decides that he should purchase a security, it would be equally foolish to sell it to him short.

I have done a great deal of business in Europe where I have many friends. I went there about a year ago and talked with a number of them about our economy here. They were unable to comprehend how we could go from what they consider the finest auction market in the world—an agency market—to a dealer market where there are large spreads.

They were also of the opinion that a great many ambitious young men in Europe over the years have came to the United States feeling that it is the one place where they could obtain the capital to start a small business of their own. The record shows that many of these young men have settled in various States throughout the Nation and have become successful and prosperous due to the flow of capital provided by regional firms. This, in my opinion, is the strength of our country.

Investment firms in Europe during the last few years have been studying and copying our methods of raising capital. Previous to this, the only capital available in Europe was for corporations with earnings of at least $5 million annually, and no money was available for new ventures.

In this country less than half a century ago companies such as Xerox, General Electric, IBM and Ford were just starting and have become enormously successful because of the flow of capital which they have been able to secure through our investment banking system.

In other words, the success of our capitalistic system is due to the efficient labor, sound management and adequate flow of capital available.

Over the past 5 years, I have been working with 55 regional firms located in almost every State of the Union. It is my opinion that these firms are essential in raising capital for industries in the States in which they are located, and I am concerned that many of them will be forced to merge or dissolve unless equal rules for everyone in our industry are enforced.

Our securities market, which is still the finest one in the world, has survived for over 200 years. Over that period of time, rules have been

periodically changed to bring it up to date. The last major changes were made in the 1930's, and I believe all agree that we should take another look at this time. I do, however, feel that we should be careful not to destroy a system which has worked well for a long time.

Our present market system consists of the New York Stock Exchange, the American Stock Exchange, four regional exchanges, the NASD and the third and fourth markets. It is not easy to formulate rules which will treat all segments of the market fairly and equally.

The rules of the NYSE and the ASE are far more severe than those of the remainder of our industry. Obviously, the interests of the investing public must be protected, and I hope and believe that a new central market system with equal regulations for all can and will be established in such a way that the securities market will prosper and serve the public well.

Senator WILLIAMS. You are very persuasive, Mr. Clark. I know you are friends with Senator Brooke. I am surprised he is not a cosponsor of this.

Mr. CLARK. He is a good friend of mine. I have talked to him about it and I wish he were. I know he wanted to be.

Senator WILLIAMS. Thank you very much.

Mr. WILCOX. I would like to paraphrase my remarks in the interest of time.

I am Stephen R. Wilcox. I am a general partner in the firm of Conning & Co., and we are located in Hartford, Conn.

We have no branch offices, but through our guaranteed corporate subsidiary, Fox-Pitt, Kelton, Inc., a Connecticut corporation, we have a branch office located in London, England.

We are members of the National Association of Security Dealers, the New York Stock Exchange, the Boston Stock Exchange, and associate members of the American Stock Exchange and the PBW Stock Exchange.

During 1973, 58 percent of our income was derived from orders executed on the New York Stock Exchange; 27 percent from over-the-counter transactions; 11 percent from fees for various advisory services; and 3 percent from regional exchanges.

We do not underwrite securities, nor do we take positions or make markets in securities. We will not accept margin accounts and none of our employees receive compensation based on commission income.

Last year 70 percent of our revenues were derived from institutional clients and 30 percent from individual clients.

We provide investment management services primarily to individuals and our institutional business has been developed through our research services on the U.S. insurance industry. We are a firm of 70 people, and we believe we have the largest insurance research organization within the securities industry.

I am here to speak in support of bill S. 3126.

It is obvious that the securities industry is in the process of a substantial restructuring. A great deal of capital has been lost and we feel that market liquidity has been reduced.

Part of the problem lies in the fact that the industry had its share of poor management.

I have read in several documents that the principal incentive to exchange membership had been the fixed commission rate structure.

That rate structure created the third market because institutions wanted to deal in listed securities at lower cost, and could in the third market.

To us, the high fixed commission rate structure was not the principal advantage to membership when dealing with institutions, though it was when dealing with individuals. The principal advantage was access to the floor for trading in listed securities in the auction market and the prestige associated with membership.

As a small regional firm, it was important for our clients located throughout the United States, Canada, and Europe to know we were members of the New York Stock Exchange and subject to their rules and regulations.

The elimination of a fixed commission rate structure in May of 1975 could very well result in a reversal of the conditions I just mentioned.

Unrealistic commission rates on auction market transactions could create an incentive to move to the third market to secure adequate levels of income.

There is a significant concentration of investor interest in relatively few securities, most of which are listed on the New York Stock Exchange.

It would seem logical to me that the major firms accounting for a significant portion of the transactions in these securities will be required to examine their capital utilization having in mind the making of markets in these securities.

Should they elect to use their capital in listed security market making, their absence from the auction markets probably would not materially affect the liquidity of the markets in a few hundred of the Nation's largest and most actively traded securities.

It would in our view, however, severely affect the liquidity of the remaining securities traded in the auction market and adversely affect the position of the individual investor.

It would also require the reallocation of capital away from other uses to what may be a higher risk use. It would negatively impact the knowledge and visibility associated with the auction market, especially for institutions and traders while managing the execution.

We would add parenthetically that the best defense to this problem should also include continued upgrading in the quality of the specialists, the number of specialists, and the minimum capital requirements for specialists.

The advantages of the auction market include disclosure, equal client treatment, and greater market breadth and liquidity. The dealer market often means appropriate competition for the below average specialist.

Therefore, we feel that until there exists a central market system, it is desirable that both the auction and dealer markets be retained and not be given the opportunity to adversely affect each other.

The SEC must have the authority to act if developments prove disruptive to the markets and the public interest.

We look at our business as a commitment to providing the best possible investment management services to individuals and the best possible insurance research specialization to individuals and institutions.

For institutions, we could deal in either the dealer or auction mar-

kets, but probably less effectively as either a member or nonmember in a weakened auction market.

For individuals, the auction market is clearly the best market for transactions. It is essential that the institutionalization of the market not be allowed to dominate the securities business and therefore further reduce the relative position of the individual investor.

Ralph Waldo Emerson said, "If a man has good corn or wood or boards or pigs to sell, or could make better chairs or knives, crucibles or church organs that anybody ele, he will find a broad, hard-beaten road to his house, though it be in the woods."

For country brokers, surviving in the woods, not only entails having something better, and doing your best to keep it better, but also requires the availability of market information, disclosure and visibility which the auction market provides. A fail-safe device as recommended by Senator Williams in bill S. 3126 is essential.

Thank you for allowing me to testify.

Senator BIDEN. Thank you.

Ralph Waldo Emerson also said "the society is like a wave, the wave moves on, the particles remain the same." I think that is an appropriate summary for the remarks you fellows have made. Unfortunately you came at the tail end of this.

I appreciate your giving the testimony. I am not going to belabor you all as I did the previous panel.

With respect to the previous panel, and for the people who are in front of us now, I would like to say that the purpose of my questioning before was to try to point out that we are not at the edge of the precipice. We are not about to go over. We are not about to go under. The Nation is not about to fall, and the industry is not about to fall, and that was the reason for the line of questioning.

I may have come across a little harsh, but it is because I am new. I'll get better, I will probably get worse in getting better, but I will get better.

With respect to absence of the chairman, he said he was leaving, I am in trouble. I assume he meant because he was late for a 6:00 appointment, not because he left as chairman of this subcommittee.

I really don't have any question at all. If you would like to make additional comments or statements, please do.

If not, we will move to the next panel.

Thank you.

[Complete statements of the preceding witnesses follow:]

STATEMENT OF STEPHEN R. WILCOX, GENERAL PARTNER OF CONNING & CO.

My name is Stephen R. Wilcox, I am a General Partner in the firm of Conning & Company, and we are located in Hartford, Connecticut. We have no branch offices but through our guaranteed corporate subsidiary, Fox-Pitt, Kelton, Incorporated, a Connecticut corporation, we have a branch office located in London, England.

We are members of the National Association of Security Dealers, The New York Stock Exchange, The Boston Stock Exchange and Associate members of The American Stock Exchange and The PBW Stock Exchange. During 1973, fifty-eight (58) percent of our income was derived from orders executed on The New York Stock Exchange, twenty-seven (27) percent from Over-the-Counter transactions, eleven (11) percent from fees for various advisory services and three (3) percent from regional exchanges. We do not underwrite securities nor do we take positions or make markets in securities. We will not accept margin accounts and none of our employees receive compensation based on their commission income.

Last year seventy (70) percent of our revenues were derived from institutional clients and thirty (30) percent from individual clients. We provide investment management services primarily to individuals and our institutional business has been developed through our research services on the United States Insurance Industry. We are a firm of seventy people and we believe we have the largest insurance research organization within the securities industry.

I am here to speak in support of S. 3126. We do this in that we believe it is essential that both the auction and the dealer markets are maintained in the interests of the public and the securities industry.

It is obvious that the securities industry is in the process of a substantial restructuring. In recent years a significant number of firms have failed and/or gone out of business. A great deal of capital has been lost and we feel that market liquidity has been reduced. Certainly part of the problem lies in the fact that the industry had its share of poor management. However, we also feel that the attitude taken by some that a commission rate reflects only the cost of an execution of an order, jeopardizes the health of the market and the brokerage services to which the public should be entitled. I have read in several documents that the principle incentive to Exchange membership had been the fixed commission rate structure. That rate structure created the Third Market because institutions wanted to deal in listed securities at lower cost and could in the Third Market. To us the high fixed commission rate structure was not the principle advantage to membership when dealing with institutions, though it was when dealing with individuals. The principle advantage was access to the floor for trading in listed securities in the auction market and the prestige associated with membership. As a small, regional firm, it was important for our clients located throughout the United States, Canada and Europe to know we were members of The New York Stock Exchange and subject to their rules and regulations. The elimination of a fixed commission rate structure in May of 1975 could very well result in a reversal of the conditions I just mentioned. Unrealistic commission rates on auction market transactions could create an incentive to move to the Third Market to secure adequate levels of income. Additionally, it does not require disclosure of the profit or loss and it does not require equal treatment for customers, which surely will be in the interest of larger customers and not in the interest of the individual investor.

There is a significant concentration of investor interest in relatively few securities most of which are listed on The New York Stock Exchange. It would seem logical to me that the major firms accounting for a significant portion of the transactions in these securities will be required to examine their capital utilization having in mind the making of markets in these securities. Should they elect to use their capital in listed security market making, their absence from the auction markets probably would not materially affect the liquidity of the markets in a few hundred of the nation's largest and most actively traded securities. It would in our view, however, severely affect the liquidity of the remaining securities traded in the auction market and adversely affect the position of the individual investor. It would also require the reallocation of capital away from other uses to what may be a higher risk use. It would negatively impact the knowledge and visibility associated with the auction market, especially for institutions and traders while managing the execution.

We would add parenthetically that the best defense to this problem should also include continued upgrading in the quality of the specialists, the number of specialists and the minimum capital requirements for specialists.

The advantages of the auction market include disclosure, equal client treatment and greater market breadth and liquidity. The dealer market often means appropriate competition for the below average specialist.

Therefore, we feel that until there exists a central market system, it is desirable that both the auction and dealer markets be retained and not be given the opportunity to adversely effect each other. The SEC must have the authority to act if developments prove disruptive to the markets and the public interest.

We look at our business as a commitment to providing the best possible investment management services to individuals and the best possible insurance research specialization to individuals and institutions. For institutions we could deal in either the dealer or auction markets but probably less effectively as either a member or non-member in a weakened auction market. For individuals the auction market is clearly the best market for transactions. It is essential that the institutionalization of the market not be allowed to dominate the securities business and therefore further reduce the relative position of the individ-

ual investor. This could ultimately threaten the economic growth of our country. It is essential that we maintain a broad market with public participation.

Ralph Waldo Emerson said, "If a man has good corn or wood or boards or pigs to sell, or could make better chairs or knives, crucibles or church organs than anybody else, he will find a broad, hard-beaten road to his house, though it be in the woods." For country brokers surviving in the woods not only entails having something better, and doing your best to keep it better but also requires the availability of market information, disclosure and visibility which the auction market prvoides. A fail-safe device as recommended by Senator Williams in Bill S. 3126 is essential.

Thank you for allowing me to testify.

STATEMENT OF DAVID H. KLANN, SENIOR VICE PRESIDENT AND DIRECTOR LOEWI & CO., INC.

My name is David H. Klann. I am a Senior Vice President and Director of Loewi & Co. Incorporated, a regional investment banking and broker/dealer firm headquartered in Milwaukee, Wisconsin.

I am pleased to appear before this Subcommittee to support this Bill, S. 3126, as an important means of assuring broker/dealers of the ability of the Securities and Exchange Commission to act promptly to preclude a possible mortal danger to this and other regional firms in the event of certain conditions. Effectiveness of this measure will be realized by adoption in its original form, without weakening changes.

Loewi & Co. is recognized as a leading "regional" firm in the United States. The firm was founded in 1928 by J. Victor Loewi, who is still a very active Chairman of the Board and through the years has done the initial and/or additional public financing for a great many Midwest corporations, both large and small. Revenues total about $13,000,000 in 1973, derived substantially from investment securities transactions with individual and small institutional clients. In addition to retail brokerage, major areas of activity include Corporate Finance, Corporate and Municipal Bond Underwriting and Trading, over-the-counter market making, and, to a modest extent, business derived from large institutions. We are members of the New York, American, Midwest, and PBW Stock Exchanges, the Chicago Board Options Exchange and the Chicago Mercantile Exchange. Loewi has thirty-five offices in the four midwest states of Wisconsin, Illinois, Iowa, and Minnesota, plus an office in New York City which limits its activities to Municipal Bond Underwriting, trading and sales, coordination of NYSE and ASE floor activities, and OTC market making activities. We have approximately 150 full time reigstered representatives, employ about 480 people in total, and have approximately 160 shareholders. We sent year-end statements to about 50,000 customers reflecting 1973 business.

S. 3126 is important to the interests of public customers. S. 3126 would require the Securities and Exchange Commission to take specific action to maintain viable auction markets during a period of substantial change in many aspects of the securities business.

We are not afraid of change! Loewi & Co. and other leading regional broker/dealers have and will continue to change and adopt new business techniques and corporate life-styles, reflecting our clients' changing needs and interests. But multiple, simultaneous and significant changes such as we are anticipating carry a very real possibility of short-term dislocations in the sensitive flow of market orders. The individual investor's interests would not be served by such dislocation—however temporary.

As a regional firm modifies and adapts to the changing needs of its public customers, in an increasingly strong atmosphere of federal, state, judicial and industry regulatory requirements, it must have the ability to compete fully and fairly in pricing its services. The free flow of buy and sell interest must set the price of the security . . . the firm can put an additional price on the value of its service to the client. To co-mingle the price of the stock with the broker's own charge for services will put the regional firm at a severe disadvantage as to its ability to cross orders internally at a price determined by negotiation rather than auction. It seems inequitable for the public investor to pay the price for a security relative to an open, highly regulated market place, while 10% or more of the orders—which would otherwise have a significant beneficial effect

in that market place—are executed under semi-protected conditions of the third market. I believe the SEC must have the ability to recognize the potential existence of such a problem and react to it, without further delaying pressures from well-meaning but parochial elements of the securities industry.

A basic attribute of an auction market is the physical convergence of *all* interested buyers and sellers in a relatively limited, defined area. An auction market must not be viewed in the abstract. Many real but undefinable characteristics are part of its makeup . . . the number of people involved, level of physical activity . . . all provide an essential atmosphere or environment to this optimum market place. These elements cannot be present in a dispersed dealer market. Exposure and execution of all orders, large and small, in the environment and pressures of this open market place will assure individuals and small institutions that they are neither at an advantage nor disadvantage in their ability to buy or sell a stock. And that is all they *really* want—an equal chance to participate.

In the Introduction to his recent report to Treasury Secretary George P. Shultz, Professor James Lorie stated, "The characteristics of the American capital markets which have produced these results are numerous, but among the more important are the fact that *investors feel they can buy at the lowest available and sell at the highest available* and the fact that the generation and flow of relevant information is relatively rapid, accurate and complete."[1] (emphasis added). Under conditions of competitive commission rates and absent a requirement that all transactions be executed in an auction market, the flow of orders could likely be substantially disbursed into many dealers' own trading rooms. The small investor has little confidence in any activity taken on his behalf in an atmosphere of less than complete openness and freedom. The regional firm, in many ways, is uniquely able to serve the needs of the public investor; this completely open and full auction market gives the small public individual and institutional investor the optimum opportunity for equal treatment in buying and selling securities through his regional broker/dealer firm.

A potential danger exists in equating the auction market with a dealer or negotiated market even when the latter become subject to full reporting requirements. A dealer market offers selected clients the potential opportunity to avoid or subvert the current market price. An auction arena puts *all* the forces of supply against *all* the forces of demand . . . openly, equally. The price at any moment becomes the focal point in a fully competitive auction market. The individual and small institutional public customer trusts this market place. If the debilitating effect of a dispersed dealer/negotiated market should threaten, this legislation would bring about rectifying action to redevelop the liquidity once present in the auction process. At stake is the ability of the individual public customer to participate equally. A multitiered market tends to breed doubt, uncertainty, and lack of credibility—none of which is needed in this psychologically sensitive market place.

I have referred to the potential impact on Loewi customers if all or some of these adverse effects and concerns come to reality. Our thirty-five retail branches in Wisconsin, Illinois, Iowa and Minnesota are located in thirty-one communities. Of these, twenty-one communities are served *only* by Loewi and other regional firms:

State	Number of communities	Number without national firm representation
Wisconsin	15	11
Illinois	10	6
Iowa	5	3
Minnesota	1	1
Total	31	21

Of our 150 registered representatives, sixty-four or 43% are located in areas not served by national firms. Their relationships with customers and services are not comparable to a WATTS-line phone call . . . our communications are not

[1] "Public Policy for American Capital Markets," prepared by James H. Lorie for submission to the Secretary and Deputy Secretary of the Treasury, February 7, 1974.

limited to those at the time of a transaction—individual or corporate—but afterwards as well. Regularly, frequently. Our brokers and associates are part of the same community life as their customers, and we must live daily with recommendations, advice, quality of service and eye-to-eye integrity. Many corporations would not have local brokers to serve their needs and those of their employees . . . public and private financing could not have been accomplished in the past without this close-at-hand relationship. The interests and needs of our public customers will be compromised should Loewi & Co. find itself in a competitive situation less open than an auction market; our financial strength, operation capabilities, and determination to offer the best service available to our clients/neighbors would be significantly dissipated.

We strongly believe that S. 3126 in its original form will provide the means whereby the needs and interests of the small public investor could be protected in the event that market conditions are likely to become adverse to such public interests.

I wish to thank the members of this committee for permitting me the opportunity to express my views on this measure.

STATEMENT OF FORRESTER A. CLARK, H. C. WAINWRIGHT & CO., BOSTON

I am Forrester A. Clark, a senior partner of H. C. Wainwright & Co., an investment banking firm that originated in Boston over 100 years ago. We are members of the New York, American, Midwest and Boston Stock Exchanges and an associate member of the PBW Stock Exchange. In connection with our securities brokerage business our firm has established a reputation for providing a high quality of investment research for our customers, and we have maintained a large staff of professional investment analysts to support that service.

I strongly *support* S. 3126 as necessary to preserve the effective auction market system which exists in the national securities exchanges of this country.

There are two major reservations which I should mention as major factors in urging that this bill not be weakened in any way.

First, I, in company with many securities firms in Boston and throughout the country, still believe that minimum commission rates are in the best interests of investors and securities markets because we believe that competitive rates generally will result in (i) lower commissions for institutional customers and higher rates for small individual investors, (ii) less investment research available to the average investor who does not choose to pay separately for it, and (iii) the demise of many regional securities firms which have served important functions in underwriting and distributing new issues and in bringing the orders of many small investors into the securities markets. However, since we now assume that we will be operating under competitive rates about May 1, 1975, we emphasize that elimination of minimum rates will eliminate a major incentive to membership on stock exchanges.

The auction market system embodied in stock exchanges, with whatever shortcomings it may have, is the best and most effective market system known in the world today, serving both small investors and institutional investors. The elimination of minimum rates will create a basic business decision for many members of stock exchanges, whether it may be more profitable for them to execute many of their transactions away from the exchange in the dealer market at a substantial markup. I believe that this is a likely result, unless legislation is adopted requiring transactions in listed securities to be excuted on an exchange, and I think that it would be unfortunate for small investors and institutional investors.

Secondly, believing strongly in the importance of assuring the continuance of effective auction markets with depth and liquidity after the advent of competitive rates, I would strongly prefer a direct statutory requirement that all transactions in listed securities be executed on an exchange. If an alternative to the foregoing is necessary. I urge adoption of S. 3126 to assure that, if the conditions specified in that bill are met, the SEC by rule shall prohibit brokers and dealers from executing transactions in listed securities away from an exchange.

A few of the primary reasons why I feel customers are best served by requiring that all transactions be executed on an exchange are these:

(1) Transactions there are executed on the basis of the best available competitive price at a given moment in the auction market, rather than at a negotiated price with a single dealer.

(2) There are continuous markets in listed stocks, with dealer participation by specialists only when the supply or demand is insufficient to handle customers' orders.

(3) There is full *disclosure* of all transactions and *all* customers have an opportunity to participate at the best price available.

(4) Funneling of all transactions into exchanges provides depth and liquidity by concentrating the volume there, rather than spreading transactions. This should be particularly important to institutions in bringing together in the auction market an accommulation of small orders to provide the depth and liquidity necessary to preserve values of investments in their portfolios.

Finally, I would like to reject claims which are frequently made that a requirement for execution of all transactions in listed securities on exchanges are anticompetitive, because the proposed requirement would *permit* and *encourage* competition within the central market system by any dealer desiring to compete. The proposal would not force socalled third market firms out of business. They would be free to participate as any other non-member of an exchange under competitive rates on the exchange, and the major third market firms already are members of one or more regional exchanges.

For all of the reasons summarized above, I feel strongly that S. 1326 should not be weakened in any way and that the language should be retained that, if the prescribed conditions are triggered, the SEC *shall* impose the prescribed prohibition, recognizing the authority in the bill for the SEC to prescribe any necessary exceptions.

From meetings with other firms in Boston to discuss these problems, I believe that the foregoing views represent a strong consensus of the firms in Boston. I appreciate the opportunity to submit these views to the Committee.

Senator BIDEN. Mr. Weeden, Mr. Keefe and Mr. Freeland are the next panel.

STATEMENT OF DONALD E. WEEDEN, WEEDEN & CO., ACCOMPANIED BY H. THEODORE FREELAND, AMERICAN SECURITIES CORP., AND HARRY V. KEEFE, KEEFE, BRUYETTE & WOODS, INC.

Mr. WEEDEN. Yes, sir.

Senator BIDEN. I don't want you to leave out anything in your prepared testimony, but if you feel you could summarize it more appropriately, do so and the entire statement will be put in the record.

If not, I am delighted to and will stay here as long as you all have.

Mr. Weeden.

Mr. WEEDEN. I think I go first.

Senator BIDEN. I believe you are listed first, so why don't you go first?

Mr. WEEDEN. I feel I have already testified.

I should start by saying I thought there was some unfairness in the makeup of these hearings with so little time allowed the third market people to defend their position. But having heard the other testimony, I realize that having been allocated 5 percent of the hearings which is about the amount of business we do in listed securities, it was probably fairly organized.

Mr. Chairman, in the absence of the chairman, Senator Biden, I would like to say that I worked very hard on my testimony and complete with all the needles that I thought were appropriate. Some people said that they were harpoons.

I would like to dispense with the formal testimony if you would accept it into the record.

Senator BIDEN. Fine, but please don't do it because of the hour, because we are here to give you an equal opportunity to testify.

Mr. WEEDEN. I appreciate and certainly if anybody has any questions on that testimony, I would be delighted to answer them. Included in that testimony is a copy of an ad that Weeden & Co. placed in the Wall Street Journal in February of this year which indicates the type of business we do (see p. 163).

It is a rather detailed explanation of that business and I would welcome questions on the nature of that at any time. There are a number of questions that have been raised and I think it might be appropriate due to the lateness of the hour, to really meet some of those questions about the third market and Weeden & Co.

First of all, I would like to say that I appreciated having the annual report of Weeden & Co. for 1973 brought into the hearings, by using it as an example of how profitable it is in this business. Having lost about $3 million in that year, I thought that annual report in fact explained just the opposite. I just wanted it to be made clear to this subcommittee that the dealer business over the last year has been a very difficult business and one that I would not call terribly profitable.

I would next like to explain how A.T. & T. does their buying and selling in the third market, inasmuch as that particular point was brought up.

They have, I would say, hundreds of thousands of shareholders, many of whom are employees. One reason for that is that many of them have confidence in that company and also in the past they have had a number of stock purchase plans which allowed their employees to buy at a discount American Telephone stock.

I would say for some 20 or 25 years, Weeden & Co. has provided a service to the employees of the telephone company in that we have been prepared to buy and sell small lots of telephone. First of all directly with the employees, and at the present time through the offices of the company.

We do that for the American Telephone Co.; the New York Telephone Co.; I believe we do it for the Pacific Telephone Co.; and so on.

The nature of that program is that they have coming into their central office, I think it's at 195 Broadway, indications to sell principally, and in some cases to buy, small amounts of Telephone stock which we are prepared to do upon the call from the Telephone company itself at an amount equal to the odd lot differential based upon the last public price at the time the call comes in.

In effect, what we do is provide a service for the telephone employees who use that facility without any commission or other charges—except for a $5 transaction charge for odd lots. The profitability to Weeden is in the spread between the odd lot bid and the offer similar to that which the odd lot dealer makes on the floor of the exchange.

I can't tell you how much business is done that way; I do know that in 1973, we did some 2,500,000 shares in round lots and approximately 350,000 shares of American Telephone stock in odd lot amounts. I think the average was about 30 shares.

I also believe that the Telephone Co. has a dividend reinvestment and stock purchase plan where they go into the market periodically to buy stock. I believe the way they do that is to search out the best net offering to them whether it's the exchange offering plus commis-

sion or the third market, putting us into competition with one another, and they buy from the best market at that time.

I would now like to explain how S. 3126 kills the fourth market. In effect, the fourth market would be unable to come onto the floor of the New York Stock Exchange. It would be unable to get membership there; and, therefore, to the extent that S. 3126 goes through to its logical conclusion that kind of business is eliminated. That is, off-board business being done by these nonmember broker-dealers is eliminated. It would then be impossible for them to continue their existence.

I think it's also appropriate at this time to mention the 2,000 or 3,000 nonmember broker-dealers who are making use of the third market in merchandising quality securities to their customers. I think you will find in our report of transactions during the fourth quarter of 1973 that a substantial amount of our business was done in odd lots and small round lots. Much of that is done with nonmember broker-dealers who are dealing directly with and servicing the small public investor. To the extent that they can get a competitive bid or offer for their account, they can turn around and charge what we call the full commission or the standard fixed commission appropriate for listed stocks at the present time.

Now, to the extent that the third market makers are required to join exchanges, they could not do business in this way. It would eliminate the opportunity for these small broker-dealers to do that business in a manner that allows them to receive and retain the full commission.

We have heard testimony here and particularly in past hearings before the SEC where many, many member firms have complained that they cannot make money on agency transactions in small amounts at the present fixed commissions even though they retain the full commission.

I can't conceive of how the small broker-dealers can possibly make any money if they can only receive 40 percent of the commission in going through members firms. You have to keep in mind that that 40 percent rebate or discount that they get is only a couple of years old and I would suggest that the reason that that discount was put forward by the New York Stock Exchange was the fact that there was competition from the third market by providing a market and that we essentially had taken that business away from them in order to facilitate and encourage nonmember broker-dealers to merchandise quality listed stocks to their customers and make a reasonable profit.

Next, I would like to make clear whom the SIA represents. I think the name Securities Industry Association is somewhat misleading. I am not familiar with the more recent figures, but I believe that there probably are 3,000 to 4,000 registered broker-dealers in the United States.

SIA has a membership of 743. Keep in mind most of those registered broker-dealers in our industry are registered with an exchange or the SEC or the NASD, and they are not members of any exchange.

Senator BIDEN. Are you a member of the SIA?

Mr. WEEDEN. Yes, we are. We are in these statistics. They have 743 members; 52 percent, just over 50 percent, a significant figure, are New York Stock Exchange members. If you eliminate the banks from that figure of 743, then 59 percent of the membership of the SIA are members of the New York Stock Exchange.

So I suggest that that membership which is about 20 percent of the total membership in the entire industry probably doesn't represent the opinions and attitudes of the entire industry. In fact, some people have facetiously suggested that they ought to change their name to the Association of Stock Exchange Firms.

Senator BIDEN. If I may. Is there any reason why you stay a member?

Mr. WEEDEN. That is a good question and that is something that has been raised in our executive meeting. We feel that our relationship with the municipal bond industry suggests that we ought to remain as part of the SIA at the present time but quite clearly, the SIA doesn't reflect our attitude in terms of how listed securities ought to be traded.

Senator BIDEN. Do you show up at meetings?

Mr. WEEDEN. I don't. My brother Alan does. He is the nice one of the family. He gets along with all of them.

Now, I wanted to mention that the Thill case, which has been mentioned previously, when some testimony from that case was put into the record, was tried in the spring of 1973.

The quotes in my statement which I submit into the record are from——

Senator BIDEN. They will be reprinted in the record in full.

Mr. WEEDEN. Thank you.

They are from the sworn testimony and I believe would still be relevant. Now I have no objection to a man changing his mind, but I bitterly resent others to claim to speak for those New York Stock Exchange member firms who are supposedly about to quit the exchange. I frankly don't believe it, and I think that you will find other testimony in the Thill case that will support the three quotations that appeared in my testimony here.

Now, I think we have alluded already to the fact that the third market, at least speaking for myself, Weeden and Co., does service small investors. Most of our transactions, 80 percent in fact, are in amounts less than 500 shares. We service them as I mentioned through corporate facilities such as the American Telephone Co., the trust departments of various banks, our relationship with nonmember broker-dealers around the country and also our relationship with various regional exchanges.

Another point that I thought might be useful to mention is that Weeden never sells on the New York Stock Exchange. That is our policy. All the testimony that we have heard here and before as to dumping inventory on the exchange is garbage. Nor do we sell short, nor have we over the last 20 years either, on the exchanges or through our direct relationships with institutions in any manner that would not be permitted on the New York Stock Exchange.

We have been advocates of full disclosure for a long time. That has been stated in testimony by many third market people and my testimony and statements to the public over the last 5 years. I also remember back in 1964 when we talked with Mr. Pollack and Gene Rotberg at the SEC about how and if a short selling rule for third market dealers is necessary in the public interest.

I believe that the SEC is very close to that and will provide the necessary regulation when they feel it's appropriate. In fact, the SEC has, this month, proposed a new short selling rule to apply to all

markets reporting on the composite tape—the NYSE, the regional exchanges, and the third market.

Fifth—or 10th, I am not sure which I'm on, I don't think there is any mystery about how we operate.

The way Weedon & Co. and our third market activity conducts itself from day to day has been a matter of public information for several years. We have always had an open house to any and all who are interested and I extend an invitation to the chairman of the board of governors of the New York Stock Exchange to come and visit us and to see for himself how we operate.

I think with those few statements that maybe clarify the record, I would be very happy to answer any questions that the subcommittee wishes to direct to me.

[Mr. Weeden subsequently requested the following information be made part of the record:]

WEEDEN & CO., INC.,
New York, N.Y., April 4, 1974.

Hon. HARRISON B. WILLIAMS,
U.S. Senate,
Washington, D.C.

DEAR SENATOR WILLIAMS: In Mr. Needham's testimony before your Subcommittee last Thursday he made reference to a disruptive third market participant at an industry meeting on equal regulation. I admit to being that third marketeer, but pass on the disruptive.

The enclosed minutes of that meeting (which Mr. Needham did not attend) should make the record clear on what actually took place.

Respectfully,

DONALD E. WEEDEN,
Chairman, Board of Directors.

MINUTES OF MEETING OF TASK FORCE ON EQUAL REGULATION

JANUARY 15, 1974

PARTICIPANTS

American Stock Exchange: Robert Birnbaum, William Silver.
Boston Stock Exchange: Robert Halligan, Frank Nolan.
Midwest Stock Exchange: Larry Augustyn, Kenneth Robenblum.
NASD: Lloyd Derrickson, Donald Weeden, Frank Wilson, Fred Siesel.
New York Stock Exchange: Donald Calvin, Donald Stone, Robert Stott.
PBW Stock Exchange: Arnold Staloff, Barry Tague.

The meeting was held at the office of the New York Stock Exchange. It began at 2:30 p.m. and adjourned at 5:30 p.m. The first order of business was the selection of a Task Force Chairman, Co-Chairman, and Executive Secretary. Robert Birnbaum was voted Chairman; Kenneth Rosenblum, Co-Chairman; and Fred Siesel, Executive Secretary.

The meeting was held at the office of the New York Stock Exchange. It began ing. (The NYSE prepared a draft agenda for the Task Force meeting based on an earlier paper discussing their rules titled "Equal Regulation and a Consolidated Tape System for Listed Securities".) The issue was whether the Task Force was to consider what regulation, beyond that endorsed by the Commission and its Industry Advisory Committee, was appropriate in all markets prior to a Consolidated Tape or, given a Consolidated Tape, prior to a Central Market System. No agreement was reached on the purpose of the Task Force.

The discussion next turned to the possibility of developing a joint statement separating the Task Force discussions from the start-up of the Consolidated Tape. Attempts were made to develop a statement to the effect that any Task Force discussions on equal regulation do not involve any presumption nor implication that the Consolidated Tape be delayed. There was substantial agreement on such a statement but the NYSE representatives did not agree.

The participants agreed that prior to another meeting they would develop a joint agenda and complete a compilation of rules on various markets started by the American Stock Exchange. No new meeting was scheduled.

Respectfully submitted,

FRED SIESEL,
Executive Secretary.

Senator BIDEN. I would like to do something a little out of order. Since the other two gentlemen will not be able to leave after you give your statement, I may have questions, and since you have been the major antagonist or protagonist, depending on the point of view, and since it is fresh in my mind, I would like to ask a few questions and come back without going into depth.

To make sure I understand, yesterday Chairman Garrett told us that individual investors do not deal in the third market; yet you seem to indicate that they do deal in the third market.

Mr. WEEDEN. Well, if you think of us as a specialist, which is the way we think of ourselves, or market-maker, the public doesn't deal with a specialist either, does he? The public does not deal directly with the specialist, although specialist firms might have a few individual accounts of their own.

Therefore, in that sense, we don't deal directly with them. But many, many public investors benefit from the existence of our markets through the facilities of nonmember broker dealers, through the facilities of bank trust departments, custodian accounts.

Senator BIDEN. Can that fictitious Aunt Millie, or whoever, can she come in and open an account with your firm?

Mr. WEEDEN. No. Nor can she open an account with a specialist.

Senator BIDEN. I see.

The reason I raise the question is because the rationale for not having controls on third market firms that are on the exchange is that they don't deal directly with individual investors. That was the rationale at least Chairman Garrett gave us.

I though maybe you had contradicted that.

Mr. WEEDEN. I wouldn't contradict Chairman Garrett in these hearings.

Senator BIDEN. OK.

I did take the time to read your prepared statement, as you probably observed by the questions I asked some of the other witnesses. The essence of your statement, as I understand it, and correct me if I am doing injustice, is that the real purpose of S. 3126 is to undermine S. 2519, and that as a justification for S. 3126, the New York Stock Exchange and proponents of that position have operated on three false premises:

The first is that competitive rates will kill the auction market. You say that is not true. The opposite will happen.

Mr. WEEDEN. I am not saying the opposite will happen. I am saying indications are.

Senator BIDEN. OK.

Secondly, that you say the second false premise is that the fair and orderly markets can exist only if stock exchanges remain a near monopoly, to use your quote.

And thirdly, you say that the SEC is equipped to decide on how much competition is good for the securities industry.

You think that is also a false premise.

They are not equipped to do that, you say.

You go on to point out that the likely possibility is that competitive rates will have the opposite effect predicted. You say that fair and orderly markets can better exist in the competitive situation that you define with the healthy third market independent and viable of the exchanges.

Thirdly, you say that the SEC is not equipped to decide how much competition is good for the securities industry, and where that line should be drawn, and then you go on to say, "Besides, the Commission already has the authority," to take remedial action, if necessary, under sections incorporated presently in S. 2519.

Is that a fair analysis of your overall approach?

Mr. WEEDEN. That's right. They already have the ability to do what is necessary to protect the public interest and to provide for fair and orderly markets.

Senator BIDEN. OK.

I just want to be sure I understood that.

I would like to go to the next two gentlemen and come back to all three of you, if I may.

Sir?

Mr. FREELAND. I am Theodore Freeland, vice chairman of American Securities Corp., New York City.

We have seven offices in this country, and one in London, England—seven branch offices in this country. We have maintained an active participation on the third market since 1952. Our list of clients includes nearly all types of financial institutions, large and small, and both private and public pension funds.

It is interesting to note that a very high percentage of our transactions takes place with clients acting in a fiduciary capacity. I would like to point out that many of them represent the little guy. I would like to get that in, because it seems to sell, and we do business with——

Senator BIDEN. We are all for the little guy and apple pie.

Mr. FREELAND. Yes, sir; we are. State pension funds and corporate pension funds do represent the little guy. We feel we have not hurt the little guy, perhaps we have even saved him a fair amount of money in the past years.

Senator BIDEN. The little guy is real good friends with the reasonable man. We have trouble finding them both. I don't know where they are.

Mr. FREELAND. Yes, sir.

I should add also that we are members of the Pacific Coast Stock Exchange, and associate members of the American, and, Senator, we are members of the SIA. We have many friends in the SIA.

Again they do not represent our viewpoint on the trading of listed stock in their presentation today. Naturally we feel competition in the industry is very much in the public interest.

We would like to point out that more than 10 years ago in the well-known special study the SEC came to the same conclusion. They tried to improve communication between the markets by forcing—if I may use that word—forcing an amendment to the restrictive rule 394 of the New York Stock Exchange.

It is well known this has proved ineffective. The third market firms have always had a very active business with the regional exchanges,

and at this time conduct a significant percentage of the business right on the trading floors of most of them.

The "Multiple Trading Case of 1941" established the fact that the New York Stock Exchange does not have and should not have a monopoly in the trading of stocks on its floor.

This decision established the right of New York Stock Exchange members to deal on regional exchanges in New York Stock Exchange listed securities.

Certainly nothing has happened recently to change the situation under which the regional exchanges and the third market working well together offer healthy competition.

As a matter of fact, the public interest would best be served by increasing marketmaking capabilities rather than passing legislation which could tend to further restrict it.

Much mention was made of the word "auction" as if there were something magic about that. I think marketmaking capability in an institutional type of market is very important and the commitment of capital to it is very important.

We feel that the SEC and the Justice Department have been well aware of our operation, and other friends of ours in the third market for some time. If we are doing something improper, they have adequate authority to hold hearings at any time they come to that conclusion.

We feel that this bill would be perhaps a sword hanging over the head of the third market. Who is to say when these hearings are held? As the Senator pointed out, is it when 5 percent of the members leave, 6 percent, or 10 percent?

This is a good question.

We feel that the legislation would be just as prejudicial as legislation confining all trading to the third market. We are not recommending that either.

I apologize for the brevity of my one-page statement.

Senator BIDEN. Oh, thank you. Don't apologize for that.

Sir?

Mr. KEEFE. I am Harry Keefe, president, founder, and principal stockholder in an investment banking firm specializing in bank stocks.

I would say the unique thing about my background is that I went the reverse of some of the other witnesses today in that I began with the New York Stock Exchange firm in 1946, became a partner of that firm in 1952, and remained a partner until 1962.

So I have worked as a partner in a major and old New York Stock Exchange firm.

I am at the present time a member of the Pacific Coast Stock Exchange. My partner is a member of the PBW Stock Exchange. So I have been affiliated with stock exchanges for my entire business life.

Now I say, I emphasize, I am not now a member of the New York Exchange. This is deliberate. You will understand as I get into my testimony.

I would like to start out by saying just sort of extemporaneously that I have resented some of the remarks made today about the third market and uneven regulation. I had thought I was subjected to the SEC and NASD, and particularly the remarks made by whatever the gentleman's name is from the stock exchange who spoke about the in-

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dividual investor being "skewered" to use his words, because of the third market.

If the individual investor has been "skewered", it is only because the New York Stock Exchange has rules such as 394 that prohibit its members from getting access to my market or Ted Freeland's or Don Weeden's.

If they get rid of that rule, the investor would have access to both markets. As to marketmaking responsibilities, when you have a competitive situation, your competitors assure that you show up each day, that you make a market each day. If I drop a stock, you can be sure Weeden's traders will let the institutional professional market know it pretty fast.

If I don't make a market, one of these guys or Morris Schapiro certainly will.

In talking of unequal regulation, one of the things I would like to ask this committee is how many have ever seen the financial statement of a New York Stock Exchange specialist, the gentlemen who enjoy monopolistic positions?

My firm is not publicly owned, but for a long while we published financial statements that conformed to all SEC disclosure requirements for a publicly owned firm. I challenge you to find a specialist firm that can make that statement. (I think that is important because marketmaking capabilities depend on your capital.) As far as short selling, this is something that is frequently brought up in hearings, the ability of the third marketmaker to short sell.

Well, I would like to pose this question, when you have multiple markets, what is the determining price?

I will give you an example, a specific example. We make a market in Northwest Bancorporation, and on 1 day the stock had sold 100 shares at 37 on the New York exchange, it was quoted 36¾ to 37¼ 100 shares by 100 shares.

I had a call from an investor who asked the market. I made it 36¼ to ¾.

He said, "I can buy 10,000 shares from Morris Schapiro at 36½." I knew that and had made my market around his (Schapiros) offering. He said, "If you compete with Schapiro, you can have the business."

I said "okay," so I sold him 10,000 at 36½ short. The last sale was 37. But what was the real market? 100 shares on the floor, or 10,000 the shares offered by Schapiro?

I went to him and said, "I will give you 36½ less an eighth for 10,000." He said, "No, thank you. My price is 36½," so I bought it at 36½ and I washed the trade.

Now, did I sell short against the market? Where was the market? When you have a number of professional marketmakers rather than one monopolistic specialist, this whole short selling thing becomes a farce and smoke screen.

If Mr. Weeden tries to play games, Mr. Schapiro and I will take care of him.

I would like to read here from my prepared testimony. To my knowledge and observation, I have never heard, read, nor known of a person sophisticated in financial markets who has cirticized the third market.

On the contrary, many economists, professors, pension plan managers, and others have spoken in our behalf. Indeed, so have many government officials, including representatives of the Treasury Department, SEC, and Justice Department.

The only objections that I personally know of that have been raised against the third market have been put forward by certain representatives of the New York Stock Exchange.

You will notice that I said "certain," since I know that the exchange membership is by no means unanimous as you noted, Senator, in quoting Mr. Solomon's report.

The most vocal opponent of the third market has not been a member of the exchange, but rather an employee of the exchange who was present here today. An employee that has never sold a share of stock, never traded a share of stock, never written a research report, never figured a bond scale, never figured a competitive bid, nor for that matter, ever worked on a P. & S. statement.

This is the gentleman who characterized the third market, and I quote, "as a high profit, low risk business."

Doesn't it seem strange that if it is so easy and risk-free to make money in the third market, that so few firms have chosen to play? Anybody can get in, just bring money.

I would like to repeat what Mr. Weeden said about 1973. Our firm has roughly $8 million in capital. In the first week in December in this easy-to-make money, risk-free business, in one week, our capital went down $1 million because we were not walking away from markets.

If you don't think that is a major decline, it wasn't your money. It was mine.

As a matter of fact, a number of senior partners in some very large and important New York Stock Exchange firms have told me personally that they look forward to the day when 394 is abolished and they can trade freely with my firm.

Senator BIDEN. Who?

Mr. KEEFE. I don't think I can appropriately say, Senator.

Senator BIDEN. Well, now, that is your choice, not to say. You are not required to. I asked everybody pointed questions and——

Mr. KEEFE. I don't think it was told me appropriately.

Senator BIDEN. I just want you to know that when statements like that are made, I take them based on whether they are backed up.

Thank you.

Mr. KEEFE. All right. They, too, recognize the competitive market is a better market. Well, I think you have a statement from Billy Solomon in essence.

The New York Stock Exchange is saying: "Join our club or get out of trading." Whereas in fact the stocks that I trade; bank stocks, I traded for many, many years before they were listed on the New York Stock Exchange.

Is mandatory membership of any business organization the American way? According to the textbooks this nation does not believe in cartels. I am not surprised, however, at the Exchange demands for there are many features of the New York Stock Exchange that are not democratic.

For example, the Board of Directors of a corporation can list its stock without shareholder approval. But once having listed the Ex-

change forces the company to sign an agreement that makes it virtually impossible to de-list. The Chairman of the large New Jersey bank and I don't know which one but it is a matter of public record in the press, has stated he would de-list but the stock exchange agreement effectively prevents that.

I personally know a number of other holding companies that would de-list if they felt they could do it. Perhaps the least democratic feature of the Exchange is the assignment of the specialist. The corporation is told by the Exchange who the specialist will be and as long as the specialist meets the Exchange's requirements—I underline that, the Exchange requirements as established by the Exchange unilaterally.

Many corporate officers expressed to me dissatisfaction with their specialist. A corporation can fire the chairman of its board, change the law firm, go from one accounting firm to another, one advertising agency to another and even change investment bankers for that matter.

But the company is stuck with the Exchange's choice of the specialist. Is the arbitrary assignment of that market making privilege the "American way?" If the auction market has worked so well and I would like to emphasize this, this auction market with a monopolistic specialist system, if it has worked so well, would all of us be here today?

If it had worked well, the gentlemen at this table would not be sitting here now. How did the third market come to be? In 1946 when I entered the securities business 95 percent of the exchange trading was done by individuals and only 5 percent by institutions.

At that time very few Americans were covered by corporate pension plans or sickness and health plans. I would like to use a simple example of my father who left high school at 17 to go to work in the Telephone Co.

The Telephone Co. was one of the earliest companies in America to have a pension plan but it was clear that the plan would not cover him on retirement. So each week he brought home to my mother some money and gave it to her and she put it in the savings bank in Boston and this said "retirement."

He had another passbook and this said "sickness." Another one that said "Harry's college." After she saved a certain amount of money they went out and bought some American Telephone stock. Let's change from my father to me now.

My corporation puts 15 percent of my salary aside which is tax free this year to me in a company profit sharing and retirement plan.

Senator BIDEN. We might talk about that, too, sometime.

Mr. KEEFE. My company guarantees me in the event of illness—and every other employee—the same take-home pay for 2 years. We have a sickness and health plan with the Aetna Life Insurance Co., that I believe is the most generous that money can buy, that the company pays for completely.

When I went to Amherst College and graduated in 1943 the University of Massachusetts had only 1,000 students and if you lived in Massachusetts you did not have much opportunity to go to that university.

Amherst at the time had 800 students. Today Amherst has 1,200 students and there are 25,000 students at the University of Massachusetts. My daughter is marrying a boy from California in June and he is going to go to medical school at the University of California. The reason he is going to go there is because the tuition is $200 and Harvard Medical is $6,500. What I am saying here is that one of the other gentlemen has mentioned there are 800,000 fewer stockholders in America.

I don't think this has a damn bit to do with the auction system and the stock exchange market. I think it has to do with the basic economic structure of our country. I don't need to save for my retirement, I don't—unlike my father.

I don't need to save for sickness and I don't need to save for education. We have developed a social philosophy that does this.

So much of the incentive for the individual to participate in the stock market has been removed, which is why I started a firm to deal exclusively with institutions because I felt that is where the action was going to be.

I submit that the individual investor no longer has incentives he has had 20 years ago to participate in the market. He no longer has the incentive to save for retirement. His company is doing that for him.

Institutions if they dominate the market, and they certainly do in the major stocks cause supply and demand imbalances—that necessitate a dealer function. That has been overlooked in these discussions. That is what my firm does, we operate as a principal to offset the imbalance of large supply and demand situations. To be a dealer takes capital, and in any institutionally dominated market, lots of it.

If this committee has not already done so I think you would find it very interesting to get the financial statements of some specialist firms. As I stated my firm has $8 million in capital, I believe Don Weeden's has $37 million. Some of the specialists against whom I compete have capital significantly less than $1 million.

As a matter of fact I am not aware of any specialist firm whose capital matches Weeden's and as a matter of fact I think it is a fact that no specialist firm has half as much capital as Weeden & Co.

I submit that the big majority of my trades do not revolve around whether an institution can save a commission but rather it is because I gave them an execution in the size that they want. I can't function in any system that proposes that I have to be a member of the exchange if my bid and ask is not displayed as an independent entity in the market.

How can you have an auction market, I submit, when the buy and sell orders do not match and that is what we get when we have this large institutional business? Institutions can cause tremendous supply and demand imbalances. Block positioners take up some of this but the block positioner can move in and out of the market and is not held to the market by competitive restraints such as the third market systems.

I submit that unless the gentlemen of the Congress and the Senate change our basic tax laws and unless this Nation undergoes a basic change in social philosophy and does away with social security, pensions, medicare, Blue Cross, and State universities, we will have

collectivized savings with huge pools of money moving around in large dollar amounts.

I do not deny that we must protect the small investor, but I also submit that we have an obligation to the schoolteacher whose sole savings are in a retirement fund. That fund, too, should have an efficient market in which to operate and if the auction market were efficient the third market would never have arisen.

A week ago I was a member of a panel queried by a member of the audience on the question of third market firms "backingaway." There was a gentleman there representing the National Life Montpelier and one representing the Girard Trust in Philadelphia, both substantial financial institutions of different character.

They testified publicly to what you must remember was a stock exchange audience that never in their professional experience had a third market firm backed away from making a market.

The crux of what I would like to finalize with is can a dealer market function side-by-side with an auction market? Certainly it can. Look at the corporate bond market as it exists today and has existed. The corporate bond market is part dealer and part auction and as a matter of fact the gentlemen from the SIA which was largely dominated by bond firms seemed to me not to be consistent if they are so concerned about having an auction stock market and make no comment about the fact that we have a dealer auction bond market.

The bond market I think is the exact example of what we need to see coming in the securities business. You have a 10 bond rule for members of the New York Stock Exchange where they have less than 10 bonds the order must go to the floor of the exchange. The order is exhibited on the floor, it is booked, the public investor gets a print and he can read about it in the newspaper the next day.

If the institutional investor does not trust the dealer market he can instruct the broker to get an execution on the floor and he gets one. The institutional or large investor feels he is capable of dealing in bonds on his own. He can negotiate with the stock exchange member or nonmember for whatever price is determined.

The bond market functions very well, thank you very much, and I have heard no criticism that it is immoral, misleading or to use the previous gentleman's words, that anybody is getting "skewered." I submit if we impose or the New York exchange imposes something on the order of a 1,000-share rule and I think an analysis of the trading in the stock exchange would show a majority of the trades with less than 1,000 shares, that if up to 1,000 shares mandatorily would have to be executed on the exchange and then commissions would be printed, all worrying about Aunt Tilly getting an execution you would see dissipate. The same men worrying about a dealer market in stocks are executing bonds for Aunt Tilly in the over-the-counter market.

Thank you very much.

Senator BIDEN. Thank you.

Mr. WEEDEN. May I submit for your information something which might answer your question to Harry Keefe and his reluctance to provide the names of the people who would be dealing with him if they were allowed to, the names of the New York Stock Exchange member firms with whom we deal daily on a negotiated basis from their order room to our trading room.

In order to execute those transactions, without having to go through the intimidation and complexities of 394, they are done on regional stock exchanges. I would be happy to submit the names of 88 some firms who have done that with us, to indicate the number of people who are perfectly willing to put us in competition with the floor of the exchange and whose experience had been that many, many times they have found better, significantly better sizes than they can find on the New York Stock Exchange floor.

Senator BIDEN. We appreciate that very much. I would like to have you do that if you would.

Mr. KEEFE. I was thinking of it in a different context.

Senator BIDEN. I thought you were from your answer.

Mr. KEEFE. Mine were luncheon conversations. We have had the same types of trade.

Senator BIDEN. I would like to start off with Mr. Weeden and ask specific questions if I may. In your statement you say indeed many stock exchange members have said competitive rates will drive the third market out of existence. Can you give me the names of some of the people who have said that?

Mr. WEEDEN. Emil Pattberg said that in testimony in 1968. I believe that statement is part of my testimony. Mr. Needham representing the New York Stock Exchange said that in testimony. That is also part of my statement. There are many New York Stock Exchange members who believe that we have managed to exist because of the fixed commission structure—performing basically a discount——

Senator BIDEN. I understand the principle. What I want to know is—it would be helpful to have the specific names and if you could submit those of any others, that you would be fine.

Mr. WEEDEN. We will do it the best we can.

Senator BIDEN. In your testimony, you make a statement which I think is very specific and I would like this backed up.

"Already the word has gone out to slow up the computer research and program development program and to resist all change and compromise on the consolidated tape."

The combined quotation service and the national clearing system. Who put the word out?

Mr. WEEDEN. From our talks with people who are part of the SIAC and probably the best thing would be to talk to SIAC and we have understood that they are making no efforts at this time to program the consolidated tape.

Senator BIDEN. Because someone has put the word out.

Mr. WEEDEN. Yes.

Senator BIDEN. Who are the people who put the word out?

Is that Mr. Needham, Mr. Keefe, is it——

Mr. KEEFE. It was not I.

Mr. WEEDEN. I would say——

Senator BIDEN. It is a pretty strong statement, you see.

Mr. WEEDEN. I think that the statement is supportable then by the fact that in the deliberations in terms of a national clearing system, which my brother Jack is part of, and I would be delighted to get a statement from him of the difficulties that they are having in terms of the New York Stock Exchange cooperating in developing a national clearing system. I think in terms of the consolidated tape, where I have

part of those deliberations, that one can effectively and appropriately say the word has gone out not to cooperate and now, I would make the presumption and I would be happy to state that here that that comes from the management of the New York Stock Exchange.

I would be perfectly delighted if there was an opportunity to hear a rebuttal to that.

Senator BIDEN. I just think it is important that that be on the record. It is a fairly bald charge and I think if it can be substantiated, if that is true, then this committee would do well to react to that.

I think we would need some more evidence of that. Maybe we should raise that question.

Mr. WEEDEN. If you take a look at the Consolidated Tape Association and their desire to have a veto power over any further progress, that is a fairly substantial indication.

Senator BIDEN. Now, Mr. Weeden, you expressed considerable dissatisfaction with the SEC's recent announcement concerning the composite tape in page 11 of your prepared statement. Where do matters stand on this project now and how do you expect things to proceed from this point?

Mr. WEEDEN. As matters stand now, there will be a meeting of the various participants in the Consolidated Tape Association to reagree on a relationship under that association that has been negotiated among themselves over a period of time and has been tinkered with by the Secuirties and Exchange Commission in negotiation with the New York Stock Exchange.

Hopefully we have a reasonable agreement that will allow us to go forward. But what I am concerned about, Senator, is that there is still so much opportunity in that Consolidated Tape Association for the New York Stock Exchange to hold it up.

I am concerned, Senator, that the anticipated 40-week period for its implementation will be longer, with the New York Stock Exchange still introducing problems—whether they are computer technology problems, whether they are self-regulatory problems, whatever those problems are—to hold up the inception of that consolidated tape.

Senator BIDEN. Now, in a letter dated March 11, 1974, Mr. Beshar, who I understand is your attorney, stated, and I quote,

> Mr. Bleakeley twice called me about the Third Market amendment and in both calls I emphasized to him that my opposition was based on the time and energy which would be devoted to the SEC hearings contemplated by the rider, which in turn would divert people from making progress on the consolidated tape, combined quotation service and negotiated rates.

Does that reflect the basis of your opposition?

Mr. WEEDEN. That reflects my opposition and I think that that is indicated at some length in my testimony.

Senator BIDEN. Precisely what is the danger you see in S. 3126? Is it the time and energy which would be devoted to the SEC hearings as your lawyer has informed us or is it the fear that your firm would not be able to continue in business if you were forced to take your trades to a stock exchange?

Mr. WEEDEN. We think that S. 2519 is a very good bill. It moves the industry—or let's say creates some further incentive for the industry to cooperate with the SEC to move forward with a central market system which will be a broader, more efficient, less costly, more competitive,

national system than we presently have. We think that S. 3126 offers the opportunity to the Exchange, which I am sure they will take, whether they have S. 3126 or not, to create delay in the evolutionary progress toward a central market system.

Senator BIDEN. Let me ask all three of you this: Do you feel that if you were forced to take your trades to the stock exchange that you would be forced out of business?

Mr. KEEFE. I wouldn't be forced out of business, but my effectiveness to make markets would go because I wouldn't show as an independent market maker competing with the floor market is what I am talking about.

Mr. FREELAND. We feel right now that rule 394, if it were used and it is common knowledge on Wall Street that it is very seldom used, that our markets would be available to members of the exchange. They would not have to leave the exchange to get into the third market.

We heard much of that today, much wringing of hands and crying about the fact that they would have to get into the third market.

I think these firms would be welcome, but why do it when 394 allows them to call us and get the best price if it is available. Therefore, I feel that our markets are already available to the New York Stock Exchange members.

Senator BIDEN. Would you be forced out of business if you were forced to have to transact your business on the New York Stock Exchange?

Mr. FREELAND. No, sir; we would find a way to stay in business and conduct an institutional business under a different setup.

Why we should be forced to do that, however, escapes me 100 percent.

But the answer is we intend to remain in business, but we would like to remain in business on a fair basis and not be told we have to join a club.

Senator BIDEN. I understand that. Fine

Mr. Weeden?

Mr. WEEDEN. Senator, I guess that if we were required to join the country club that really doesn't like us very much, that we could probably still get something to eat there but I don't think the atmosphere would be a fair and equitable atmosphere.

Senator BIDEN. For your brother it would be. They like him.

Mr. WEEDEN. No, as much as I admire his capacity to get along with people, I don't even think he would be really welcome there.

Senator BIDEN. I think you have all answered my question. I have a number of others and I am not trying to put you in a box if you would stay in business, there is no reason why you shouldn't go. I realize they are separable questions.

Mr. WEEDEN. Let's make one more point, Senator. The atmosphere on the floor of the exchange and the type of rules that they have at the present time have prevented members of the exchange, who are basically the type of firm that we are in capital, market making expertise and willingness to commit it to market making, from doing that business. They have all, in one way or another, to a greater or lesser degree, have had to accommodate the man who has that monopoly franchise and controls the public book.

I don't think that Weeden & Co., or our traders are any kind of demigods who if forced into that atmosphere would be able to do any-

thing else but accommodate, like all the other members of the New York Stock Exchange.

Senator BIDEN. Among the things Mr. Needham has pointed out in the last several years, is the fact that your firm, Mr. Weeden, does about 30 percent of your business on stock exchanges. Is that correct?

Mr. WEEDEN. Yes, sir.

Senator BIDEN. Now, how can you justify regulations which would allow you to use the exchange markets when it is to your advantage and not to use them when it is not to your advantage?

Mr. WEEDEN. I think you probably don't understand the nature of marketmaking. We are like the specialist. We just are passive marketmakers. We respond to people who ask us for bids and offers.

Now, to the extent that we are forced to join the New York Stock Exchange then when we make a bid to one of our customers, we are forced to go down and show that bid to our competitor—and keep in mind that is what the specialist is, our competitor. That is who we compete with. Not the public broker. We are competing with the specialist. If we are required to go in and show our bids to our competitor, then ultimately, because we are at such a disadvantage, we are either going to go out of the business or we are going to have to accommodate to the person.

Senator BIDEN. Do I understand correctly that the 30 percent of your business that you do do on the exchange is by choice? You opt to go to the exchange?

Mr. WEEDEN. No, no.

Mr. FREELAND. No, no to the regional exchanges.

Mr. KEEFE. No.

Mr. WEEDEN. We have Butcher & Singer or Loewi & Co., who is a member, probably the Pacific Coast Exchange and other exchanges who will come to us with a public order and put us into competition with those other marketplaces that he has available to him. He makes a decision whether we are the best or whether we are equal to whatever anybody else is doing.

Now, if we are equal or better and it is in the interest of his customer to deal with us, he makes that judgment on their behalf to deal with us. We don't go to Loewi. He comes to us.

Senator BIDEN. The point that I guess I think Mr. Needham was trying to make, the one that I am trying to bring out, is that regardless of how you got there, 30 percent of your business is on the exchange.

Mr. WEEDEN. On exchanges; not the exchange.

Senator BIDEN. That was a Freudian slip.

Mr. WEEDEN. Right. It keeps coming up here, though.

Senator BIDEN. I realize that. If someone read the testimony they would assume that you are the third market.

Mr. WEEDEN. You understand the concept that they are using here to justify our having to go to the exchange is that we pass our orders past the New York Stock Exchange book, right? Now, to the extent that that concept is accepted by your subcommittee, then why should not that concept apply to that order that goes to the Pacific Coast Exchange and avoids that same book in exactly the same way that you are accusing us is not in the public interest? Keep in mind the passage of 3126 is the first step toward eliminating all of the other regional stock exchanges.

I would be very happy to explain that to you if you have time an hour later, S. 3126 is an effort to move the central market system back to the New York Stock Exchange, not to create a national market system which will allow competition among all the existing exchanges plus the marketmakers who are not members of exchanges.

Senator BIDEN. Mr. Needham has argued that the third market is fragmented. That phrase is used, fragmenting the market for listed securities.

Mr. WEEDEN. The same argument applies to the Midwest Exchange, Pacific Coast, Boston, and I will just mention these for the benefit of the subcommittee, PBW, the Detroit Stock Exchange, and the Cincinnati Stock Exchange.

Senator BIDEN. Is fragmentation—whatever that is—determined by the pricing mechanism for securities?

Mr. WEEDEN. Fragmentation is caused by the regulations of the New York Stock Exchange that create barriers between these marketplaces. You want to get rid of fragmentation, you do two things:

You move forward with the composite tape; and you get rid of those rules that prevent Tim Clark or anybody else who is a member of the New York Stock Exchange to deal with us when he believes it is in the best interests of his customer to do that.

Senator BIDEN. But you are now, and I believe, Mr. Needham has suggested, that your primary competition in addition to the gentleman sitting with you, comes from such people as Salomon Bros. and Goldman, Sachs, is that correct?

Mr. WEEDEN. And the specialists on the floor of the New York.

Senator BIDEN. Right.

These firms are subject, at least according to all previous witnesses, to more rigorous regulations than you are.

Now if those firms are willing to subject themselves to exchange regulations to provide their customers with the benefits of the auction market, why are you not?

Mr. WEEDEN. Senator, you don't realize that Salomon Bros. and Goldman, Sachs avoid the auction market on the floor of the New York Stock Exchange all the time, and so do many, many other New York Stock Exchange firms.

Mr. KEEFE. I think, Senator, it would have been appropriate to have some of these block trading firms that are in effect operating as dealers like we do, and I think this talk of an auction market, I can submit to you that Salomon Bros. and Oppenheimer and Bear, Sterns and Smith and Stern and Goldman, Sachs, are in effect making dealer markets upstairs right now, and they are positioning these stocks and the market you see on the floor is not a public auction market, but rather reflects a dealer upstairs opinion.

Senator BIDEN. Thank you.

We have received testimony that, because many third market firms already belong to regional exchanges, S. 3126 would not impose any real hardship. These firms already take a large part of their business to an exchange, and the bill would simply require them to take all their business there.

Do you fellows belong to regional exchanges? I believe you all answered that you do.

[Affirmative response.]

How much of your business do you do on these exchanges, including those on which you are not a member? A rough estimate, please, how much of your business do you do on the exchanges of which you are a member and not a member?

Mr. KEEFE. I don't really know, Senator. The bulk of the business we do on regional exchanges is with New York Stock Exchange firms who are frustrated by rule 394, and will call us and say, "I have 10,000 shares of Western Bank Corp. to sell, how are you fixed?" And we say, well, we are looking for the stock, and they say, "We will meet you on the PBW or Pacific." They execute at the same commission because they cannot execute in New York.

When we are dealing on a regional, typically with a member firm, the only reason they come to us is that the auction market in New York will not function.

Mr. FREELAND. I would like to answer that this way:

We make our bids and offers available to the Pacific Coast Stock Exchange. It is not a case of doing order business on the exchange, per se. We make bids and offerings available all day long.

Our percentage of executions on those bids and offerings is relatively small. But we did 8 million shares last year on the Pacific Stock Exchange, and nearly all of it was New York Stock Exchange members.

That could not be done off the floor under their rules, but it can be done on the Pacific Coast Stock Exchange.

I would hasten to add that we would have been willing to do five times that much, had the other side been available there on the floor of that exchange.

Senator BIDEN. Mr. Weeden?

Mr. FREELAND. The SEC is on record as approving the off-board trading rules of the Pacific Coast Stock Exchange, the working arrangement is a good one there. It has increased rather than gone backwards.

Mr. WEEDEN. We have three types of exchange business that we do. When an order comes into a regional exchange, we, as an alternate specialist or market maker, respond to that order, and if, in the opinion of the broker, who is a member of that exchange, we have a bid or offer competitive to whatever else they see in the market, they execute. They make the decision to sell to us or buy from us. That is one type.

The second type of business is where a New York Exchange member firm calls our trading room, usually with a larger amount of stock, maybe 1,000 shares or 5,000 shares, or whatever; negotiates directly a transaction that they believe is in the best interests of their customer, having explored all the markets that are available to them, and determines it is in their best interest of their customer to deal on our bid or offering. We take that transaction to the floor of an exchange that we are both members of, satisfying whatever is in the book on that exchange, or any other bids or offerings that are available there, and we execute.

The third type of business we do that I think you alluded to, is where we initiate a transaction on an exchange that we are not members of. According to our figures for the last 3 months of 1973, we did approximately 1,483,000 shares on the New York Stock Exchange where we paid commission, where we initiated the transaction.

For your information, all of those shares were purchases—and not sales on the New York Stock Exchange. That constituted 2.7 percent of our business.

Now, I should also mention that under the rules the New York Stock Exchange has set up for providing the 40-percent discount we are not entitled to that 40-percent discount because we are acting for our own account. Therefore, we can't get the benefit of the discount. In case any of our shareholders read the testimony that Mr. Needham gave and felt that we were "skewering" our own shareholders because we were not taking advantage of the 40 percent—I am not sure that what "skewered" means, but——

Senator BIDEN. It doesn't sound good.

Mr. KEEFE. Tell you later, Don.

Senator BIDEN. One last question—actually two more.

Mr. Weeden, why shouldn't you be required to expose your orders to public scrutiny, that is to provide an opportunity for the public to have priority in the execution of orders?

Mr. WEEDEN. S. 2519 is a bill the purpose of which is to establish a national market system. It has as its base the auction market concept. When that bill is implemented, with the help of the SEC, it will provide a mechanism that will allow us to provide satisfactory priority to public orders. Now, that is going to be part of the process of developing a central market system.

Senator BIDEN. In the meantime, why shouldn't you?

Mr. WEEDEN. Let me put it back to you; why shouldn't the Pacific Coast member be required before they execute on the Pacific Coast Exchange, go to the book on the New York Exchange and conversely, why then doesn't the order coming into the New York Stock Exchange before the specialist buys or sells be required to go to the Pacific Coast Exchange to see whether there is an order on those books? Or go to the third market people to see if they are handling an order?

Does that answer it?

Senator BIDEN. No. No, it doesn't. You have asked me why—you pointed out why don't all the others. Why answer why to any of those?

Mr. WEEDEN. Because the mechanisms available at the present time don't allow for it. The purpose of 2519 is to provide a mechanism for doing that in a manner that is going to be satisfactory to the public brokers and to the market makers who are going to be competing with one another all over the country.

Senator BIDEN. Now, the basis at rock bottom of all you say is that although you could live on the exchange if you were forced to, if the triggering mechanism or whatever that is of 3126 were put into effect.

You indicate that you don't know why you should have to do that. But you could all survive.

What rules of the exchange would have to be changed before your firms could conduct their business in a competitive manner on the exchange?

Mr. WEEDEN. I have no idea what rules. But it certainly is not limited to 113 and 394. The whole pattern of rulemaking, the whole mechanical structure, the whole mechanism of the exchange would be burdensome to us. You have got to go down there and see how business is done, Senator.

Mr. FREELAND. Well, I would like to say that before that happened, of course, the Justice Department would have plenty to say about our

being forced onto any stock exchange, so I think the question is academic.

But I did answer it by saying we intend to remain in business under whatever legislation does pass. If we are forced to join the exchange by the SEC, then I assume there are other legal remedies available to us to appeal that.

But if we are forced to go on another exchange, we would, I guess, find a way to conduct our business. Under the existing rules, as Don Weeden points out, obviously our market making as now done would not be possible. How that would work, it is hard to say, because a complete new set of rules would have to be adopted if, in fact, we were invited in as market makers.

I don't think they mean it when they say they would take us in as market makers.

Mr. KEEFE. I think Mr. Freeland has pointed it out. If they took us in as market makers, and they said I could be on the floor and deal in all the bank stocks I now trade and have access to the book, and get all those nice floor brokerages which I don't get on Merrill, Lynch's booked orders, that might be something else. But I have not heard that suggested.

Senator BIDEN. That would be the only thing in your opinion, if that were suggested, that that would be the only thing that would make it competitive?

Mr. KEEFE. There is a difference now, that my market is a visible market to the world. If you have an opportunity tomorrow, you can go to a NASDAQ machine and punch in the markets for the New York bank stocks we trade, and you can see the markets that other firms are making, and we all stand there as market makers.

I would be delighted to see in that same machine along with the New York Exchange, Salomon's market and Goldman's market, because it is my experience trading over-the-counter stocks, the more market makers there are, the better the market. That is what we are arguing for.

I submit that is in the public interest. That can be documented very easily in the over-the-counter market. I would like to see not one guy on the floor, but I would love to see a lot of these member firms, market-making firms, having to put their name in the NASDAQ machine in Chase every day along with ours, like they do at Bank of America, which is not listed.

[Prepared statements of Mr. Weeden and Mr. Freeland; and a letter received from Mr. Gustave L. Levy of Goldman Sachs & Co. relative to Mr. Weeden's statement follow:]

STATEMENT OF DONALD E. WEEDEN, CHAIRMAN OF THE BOARD, WEEDEN & CO.

Mr. Chairman, it surely comes as no surprise to the members of this distinguished Securities Subcommittee of the Senate Banking Committee that my firm, Weeden & Co., the largest Third Market maker, is flatly opposed to S. 3126—in any form.

For half a century my father and my uncle—and more recently my two brothers and I—have fought the Stock Exchange—yes, and even fought when necessary the Securities and Exchange Commission as well—for the simple right to compete with the Stock Exchange in the business of buying and selling high grade stocks and bonds, direct, at wholesale. It is just that simple.

Having gotten our business up to where we bought and sold $16 billion of securities in 1973, we are not about to acquiesce in legislation which would give

the SEC the power to put us out of business if at some future date the Commission decides it is in the public interest to make life more comfortable for the New York Stock Exchange.

The Stock Exchange's star-spangled rhetoric moves me not at all. Its professional staff has a job to do—and that is to delay the advent of a national market system, except on its own terms. This Subcommittee also has a job to do—and that is to advance the cause of a central market which encourages competing market makers. That is what this fight over S. 3126 is all about.

S. 3126 is the Stock Exchange's proposal to undermine possible passage of S. 2519—and if that fails, to delay the implementation of the national market system proposed in that bill. The Stock Exchange dreads competition like the plague. It sees competition as a threat to its very existence.

In fact, of course, the Stock Exchange is over-reacting in panic. The competition called for by S. 2519 is no dread disease which will disable the Stock Exchange. S. 2519 is just a carefully planned, Congressionally enforced weight-watcher's regimen for an obese patient. Fixed commissions, like mother's milk, is a very rich diet. However, unsettling the prospect, the Stock Exchange must in time get weaned. S. 3126 will simply delay the process.

Moreover, S. 3126 runs directly counter to the spirit of S. 2519. S. 3126 is built on three assumptions for which there is no record support. First, it assumes competitive rates will kill the public auction market.

Second, it assumes that fair and orderly markets can exist only if the Stock Exchange remains a near monopoly.

Third, it assumes the SEC is equipped to decide how much competition is good for the securities industry.

All three assumptions are demonstrably false.

First, all of the testimony from the industry to date is that competitive rates will strengthen the Stock Exchange and put increased pressure on the Third Market, not vice versa. Indeed, many Stock Exchange members have said competitive rates will drive the Third Market out of business.

Second, the test of fair and orderly markets has little to do with how much trading occurs on the Stock Exchange per se—neither now nor in the future.

Third, the SEC, however well intentioned, has yet to master dealing with the Stock Exchange on important economic issues, let alone playing management consultant for the entire securities industry. Somehow the Stock Exchange always wins on the big money issues.

Short as these hearings are—just two afternoons—limited as these hearings are—mostly government experts and trade associations—still, I would have thought a reasonable concern for legislative due process would have suggested that somewhere, somehow, someone in the business would step forward and give us first hand the reasons why this bill is necessary.

It seems to me that at the minimum we should have begun these hearings with some forthright testimony by those major Stock Exchange firms which are supposedly staying up nights, losing sleep over whether to quit the Stock Exchange to join the Third Market because of the anticipated harmful effects of competitive rates, come April 1975.

Less than a year ago a broad cross-section of us in the securities business were subpoenaed to appear in a Justice Department vs. Stock Exchange lawsuit in Minneapolis. A key issue in that case was the alleged impact of competitive non-member discounts on exchange membership. In that suit, the so-called Thill Case, the same predictions about the irreparable loss of members and the destruction of the auction process were made by the Stock Exchange.

The stipulated testimony of the main Stock Exchange member witnesses in the Thill Case squarely contradicts what the Stock Exchange now claims in support of S. 3126.

For example, Donald T. Regan, Chairman of the Board and Chief Executive Officer of Merrill Lynch, testified that he did "not believe that Merrill Lynch would withdraw from the NYSE if fixed minimum commissions were abolished." Mr. Regan went on to explain that "Fixed commissions are one of the causes of trades leaving the NYSE and going to the Third Market . . . [C]ontinuing fixed rates will make it more difficult for member firms to compete with Third Market makers."

Now that was what Mr. Regan said on February 28, 1973. Perhaps he has changed his position 180° in the meantime. I very much doubt it. But either way, those who sponsor S. 3126 should have invited Mr. Regan to come down and explain Merrill Lynch's position directly, rather than letting others offer their hear-

say assumptions of Merrill Lynch's intentions. Trade association personnel are sometimes hard-pressed to reconcile the range and diversity of their members' thinking on controversial matters. From all our many conversations with member firms, neither my brothers nor I believe any of the big firms are seriously planning to quit the Stock Exchange in order to join the Third Market. Certainly all the testimony—sworn testimony—in the Thill Case was just the other way.

Take the stipulated testimony of Andrew Sage, then President of Lehman Brothers. Mr. Sage, on behalf of Lehman and himself, testified that he and Lehman "advocate full negotiation of rates for all customers regardless of size. They believe that fully negotiated commissions for all brokerage transactions would further strengthen competition in the securities industry . . . [and] that *Lehman Brothers would not quit the NYSE due to the phasing out of fixed minimum commissions;* nor would it decrease the quality or quantity of its research and advisory services." (Emphasis added.)

Last week Mr. Needham addressed some 800 executives of major American corporations at a dinner meeting of The Economic Club of New York. He compared the plight of the Stock Exchange to our nation's energy crisis—the speech was given before the Arabs lifted their oil embargo—and called for support of S. 3126 or else—"the securities auction market system as we know it today could be quickly dismembered." To avoid this frightening debacle he urged corporate America to call upon Congress to enact S. 3126 as a "bridge" during the period when member firms are getting adjusted to competitive rates and considering whether to leave the Stock Exchange to join the Third Market.

Sitting up on the dias during that speech Gustave L. Levy, senior partner of Goldman, Sachs, long-time Governor and former Chairman of the Stock Exchange. Watching Mr. Levy watching Mr. Needham give his speech, I was reminded of Mr. Levy's stipulated testimony in that Minneapolis trial when we were all under oath. In the Thill Case Mr. Levy explained:

"In August, 1968, in my capacity as Chairman of the N.Y.S.E. Board of Governors, I testified in favor of fixed minimum commission rates before the Securities and Exchange Commission in its Investigatory Proceedings No. 4–144. At that time I expressed the view that if N.Y.S.E. commission rates were to become fully negotiable, my firm would seriously consider leaving the Exchange and many other firms woull actually leave in response to the abolition of fixed commissions on the N.Y.S.E. I contended at that time that, as these firms left the N.Y.S.E. and executed their trades off-board, (i) the depth and liquidity of the auction market would be impaired, (ii) the N.Y.S.S.'s specialist system would be crippled, and (iii) the effectiveness of the N.Y.S.E. self regulation would be undermined, all to the detriment of the public interest.

"Upon further reflection since that time, and as a result of our experience with negotiated commissions on large trades, I have changed my views regarding the wisdom and desirability of moving to negotiated commission rates. I came to the view that it would not necessarily follow that the competitive determination of commission rates on transactions of all sizes would have the adverse effects I had alluded to in my 1968 testimony. *I have rejected the view, and do not now believe, that the advent of fully negotiated commission rates would be likely to cause my firm to leave the N.Y.S.E.*" (Emphasis added.)

I would think any Senator sponsoring S. 3126 and any Senator contemplating voting on S. 3126 would want to take the time to examine and weigh carefully that court testimony. Indeed some prudent men would wait until that case on a full record has been decided, rather than acting hastily on two days of hearing.

Bear in mind that Messrs, Regan, Sage and Levy have all spent their respective working lives in the securities industry, with long periods as heads of major Stock Exchange firms. Their sworn testimony and the court's decision could throw much light on the clear and present danger claim made today by Stock Exchange personnel.

Actually, if ones takes the time to dig, there is a wealth of material over at the SEC that flatly contradicts the present claims made in support of S. 3126. Frankly, I am bothered that, as the expert, objective agency, the SEC has neither volunteered nor been requested to prepare for the Subcommittee an appendix of testimony pro and con the Stock Exchange claims.

The material is there, waiting to be assembled. Take, for example, the testimony of Emil Pattberg, head of First Boston, one of the largest investment banking firms, formerly a member of the Third Market and now a staunch member of the Stock Exchange. Testifying before the SEC in 1968 at the Rate Structure Hearings, Mr. Pattberg said that if commissions were reduced and give-ups

banned—"the volume [of] transactions in NYSE listed stocks traded in the third market and the regional exchanges will become a memory . . . My guess is that the stock exchange volume would increase materially and that most stock exchange firms again would be in a position of having very high income . . . [because] a meaningful cut in commissions would hurt the third market." September 25, 1968, p. 3388, 3392.

Four years later Mr. Needham said the same thing. In testimony on July 19, 1973 before the Moss Committee, he volunteered the following—and I quote from page 997 of the official transcript:

"I would like to point out to you something else. *With the elimination of minimum fired commissions as the bill proposes, I think the real incentive of going to the third market disappears.* So I would not be troubled too much about it, were I you, for it is an obstacle, because it will be a very low obstacle and one which more people who are devoted to a cause of creating a central market would find it easy to leap over, if not merely step over." (Emphasis added.)

Now perhaps the official reporter got it all wrong. Maybe what Mr. Needham meant to say was that it would be easy to leap on the Third Market, if not merely step on the Third Market.

From where I sit, S. 3126 is no easy rider to be acted upon hastily. Most emphatically S. 3126 is not a "mere fall safe mechanism," an "interim solution" or a necessary "bridge."

None of those placating slogans is accurate. S. 3126 is the Stock Exchange's main strategy to effect endless delay—delay in implementing competitive rates—delay in starting up the consolidated tape—delay in working out the mechanics for a combined quotation service—delay in negotiating a national clearing system.

S. 3126 is nothing less than an artful end run around S. 2519. Without competitive rates, without the consolidated tape, the combined quotation service and a national clearing system, there can be no national market system of competing markets.

I cannot fathom why those who have labored so long to bring S. 2519 into being, should now be willing to sacrifice all that legislative momentum over an amendment as patently offensive to competition as S. 3126.

To those who would sincerely counsel me that S. 3126 is a bit of political expediency that will never see the light of day, I say read the complicated language. There are not two people in this room who can read this bill and come up with the same analysis of what is meant. Imagine what will happen when others, not part of this legislative process, try to reconstruct what transpired.

The mere prospect, however remote, of the Stock Exchange getting the SEC to eliminate the Third Market at some future date has already had a chilling effect on some of the complex negotiations going on within the industry and with the SEC.

Let me be more specific. On March 5, 1974 the Wall Street Journal noted that "the Securities and Exchange Commission is expected to agree to a New York Stock Exchange suggestion that the SEC hold public hearings on whether floor brokerage rates should remain fixed or be opened to negotiation between brokers . . ." The article went on to quote the Stock Exchange as hopeful that "the inquiry could be completed by April of next year."

I take it the members of this distinguished Subcommittee are aware of the significance of the date "April of next year."

Surely you must realize that the Stock Exchange wants to inextricably intertwine competitive rates and the elimination of off-board trading. The strategy is perfectly clear. Get the Commission involved in as many hearings as possible, drag them out and then ask for a delay in competitive rates come "April of next year."

Already the word has gone out to slow up the computer research and program development and to resist all change and compromise on the consolidated tape, the combined quotation service and the national clearing system.

The SEC is limited in manpower and funds. There are a few senior professionals at the Commission who have lived through the five year struggle to bring about the central market. The hell of all this last minute confusion is that the bright staffers get tired of the game of delay and ask to be reassigned to something more likely to move ahead, or they resign from the Commission and go into private practice.

The Stock Exchange is a seasoned campaigner at retreating slowly into the future. Delay is the major tactic of the beleaguered monopolist. We saw the Stock

Exchange whipsaw the Commission on Rule 394 back in 1965; on NASDAQ in 1970; and on institutional membership in 1973.

More recently, on March 8, 1974 we saw the chilling letter from the Commission to the participants in the Composite Tape Association. The Commission simply surrendered on all the big issues—veto power by the Stock Exchange, the locking in of SIAC as the processor, adopting New York's eligibility standards, and worse, giving New York the power to stop trading throughout the system. The only honor salvaged by the Commission was to get the Stock Exchange to keep the system open until 5:30 p.m. to accommodate the Pacific Exchange!

Historically, the Commission has not regulated the Stock Exchange. It has at best negotiated timidly with the Stock Exchange and at worst acquiesced abjectly. Those of us who have been supporters of S. 2519 thought the whole point of that bill was to give the Commission the unquestioned authority to get on with creating a national market system by removing the many barriers between markets, and to otherwise broaden the Commission's authority to meet new conditions as they emerge. So viewed, S. 3126, like the Martin Report, is a "Great Leap Backwards."

No one reading Section 11 of S. 2519 can doubt that the Commission would have the authority to do what is necessary to insure the maintenance of fair and orderly markets. The language is as broad as the English language permits.

Let me read the key provisions as they are found on pages 22 and 23 of Committee Print No. 2 of S. 2519:

"(5) No dealer shall make use of the mails or of any means or instrumentality of interstate commerce to hold himself out (by entering quotations in an interdealer communications system or otherwise) as being willing to buy and sell any security for his own account on a continuous basis or to effect for his own account any transaction in or to induce the purchase or sale for his own account of any security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest, for the protection of investors, or to insure the maintenance of a fair and orderly market in such security. The Commission, by rule, may require or permit the disclosure of any limited price order placed with such a dealer to such specialists, such other dealers, such brokers, and such other persons in such manner and under such conditions as it deems necessary or appropriate in the public interest or for the protection of investors to maintain fair and orderly markets or to remove impediments to and perfect the mechanism of a national market system."

I think it is a fair question to ask the draftsman of that provision to step forward at this hearing and tell the Subcommittee what area of regulation was meant to be excluded—what was left out that requires S. 3126?

The answer, I suggest, is quite clear. S. 2519 empowers the Commission to control all securities transactions by all broker/dealers through such rules and regulations as are necessary or appropriate in the public interest, for the protection of investors, or to insure the maintenance of fair and orderly markets.

What S. 2519 does not authorize the Commission to do is to administer the coup de grace to the Third Market on an assumed set of facts in order to ensure the domination of the national market system by the Stock Exchange.

To repeat, S. 3126 is built on false premises. First, it assumes that members will leave the Stock Exchange because of competitive rates in order to enter the Third Market. The evidence so far is all the other way. Competitive rates will make life more difficult for the Third Market. Members may quit the Stock Exchange, but probably because it is so inefficient and expensive.

Second, S. 3126 makes the false assumption that the test of fair and orderly markets is whether the Stock Exchange gets the bulk of the business, which is ridiculous. My firm alone already does 25% of the business in some listed stocks. Does that mean the markets in those stocks are not fair and orderly? Ridiculous!

Those are the tightest markets. Does this bill mean that the Third Market cannot increase its share of the business without risking a hearing which would put us out of business? Senators, make no mistake. Those of you who have voted for S. 2519 have voted for a national market system of competing markets, The old monopoly days of everything being bused to New York for execution when and how New York saw fit at costs abitrarily fixed by New York are over. The Regional Exchanges and the Third Market intend to give New York a run for the money—with or without S. 2519. We would like to see S. 2519 enacted into law, but we can and will manage without that bill if necessary.

Third, S. 3126 makes the false assumption that it is the proper function of the SEC to determine how much competition is healthy for the securities industry. Those who are familiar with the history of regulated industries know that that is just about the worst mistake Congress can make. Were it otherwise, Congress would not have had to play such an active role in getting the SEC on the track of supporting competition. Let us never forget that for years the Commission thought fixed rates were just fine until give-ups and rebates got so bad they became an industry scandal. It was the Antitrust Division which first blew the whistle.

When it comes to new ideas the Commission neither conceived nor particularly aided the Regional Exchanges, the Third Market, NASDAQ, Autex or Instinet. All were the result of competitive initiatives from the private sector. That is how it should be. The Commisson has had and will continue to have its solid regulatory achievements. S. 2519 should give it more confidence in facing up to the Stock Exchange.

Innovation and efficiency, however, are not traditionally within a regulator's area of expertise. The SEC ought not be attracted by the prospect of becoming a regulatory czar with the power and responsibility to allocate markets based on imperfect data. If some day it becomes necessary to decide that to maintain fair and orderly markets the Third Market ought to trade only on odd days and the Stock Exchange on even days, let the Congress decide that issue! Congress can move very quickly—witness the haste with which S. 3126 has been moved. Seriously, the truth is one can get a bill through Congress faster these days than one can get an administrative hearing at the SEC, plus necessary appellate review.

Add it all up and it becomes clear that wisdom lies in pushing ahead with S. 2519, unencumbered with S. 3126. S. 3126 was a mistake—a mistake that was improperly conceived, which should be allowed to abort spontaneously in this Subcommittee.

Thank you.

When the blue chips were down.

The fourth quarter of 1973 was one of the most unsettled in stock market history. First the Dow Jones Industrial Average went up 50 points...then it plummeted 214 points...then rose again 67 points. During this difficult period, Weeden & Co., as market maker, bought and sold more than 50 million shares* of those 262 stocks that are traded both by Weeden and on the New York Stock Exchange. Here are the details:

Volume Leaders

Stock	WEEDEN Volume	N.Y.S.E Volume	Weeden Volume Compared to NYSE Volume %
Texaco, Inc	**1,419,000**	6,869,600	20.7
Exxon	**1,184,600**	4,941,400	24.0
Kresge, S.S.	**1,128,300**	4,697,500	24.0
General Motors	**1,074,000**	9,053,600	11.9
Federal National Mortgage	**977,900**	5,440,100	18.0
Mobil Oil	**974,400**	3,292,000	29.6
Alcan Aluminum Ltd.	**908,400**	3,540,300	25.7
Ford Motor	**902,300**	5,291,200	17.0
International Paper	**844,500**	3,563,700	23.7
First National City Corp	**835,400**	5,526,700	15.1
Sears Roebuck Co.	**826,700**	2,498,500	33.1
Continental Oil	**779,200**	4,410,000	17.7
Gulf Oil	**733,200**	8,295,600	8.8

Market Share Leaders

Stock	WEEDEN Volume	N.Y.S.E Volume	**Weeden Volume Compared to NYSE Volume %**
Sears, Roebuck Co.	826,700	2,498,500	**33.1**
Mobil Oil	974,400	3,292,000	**29.6**
Oklahoma Gas & Electric	138,500	505,600	**27.4**
J. C. Penney	395,300	1,469,900	**26.9**
Central & South West	532,800	1,980,400	**26.9**
Southern California Edisor	584,800	2,195,000	**26.6**
Inland Steel	160,000	601,900	**26.6**
Florida Power & Light	372,700	1,420,100	**26.2**
Unionamerica	136,300	524,200	**26.0**
Alcan Aluminum Ltd.	908,400	3,540,300	**25.7**
Consumers Power	213,400	835,600	**25.5**
International Nickel	461,600	1,829,400	**25.2**
Caterpillar Tractor	610,900	2,431,700	**25.1**

Breakdown of our Volume by Customer

	Total Shares	Percent of Total
Banks	19,421,449	35.3
Mutual Funds	3,041,063	5.5
Other Institutions	9,469,448	17.2
Brokers — Exchange Members	16,635,648	30.3
Brokers — Non Exchange Members	4,962,677	9.0
TOTAL Market-maker volume	53,530,285	97.3
N.Y.S.E. Transactions for our own account	1,483,400	2.7
TOTAL VOLUME	55,013,685	100.0

Breakdown by Transaction Size

		Shares	%	Number of Transactions	%
Odd Lots	(1-99)	1,412,385	2.6	37,880	34.3
Round Lots	(100- 499)	7,396,600	13.8	50,291	45.5
	(500- 999)	4,934,400	9.2	9,284	8.4
	(1,000-4,999)	17,723,400	33.1	10,338	9.3
	(5,000-9,999)	11,024,800	20.6	1,994	1.8
Blocks	(10,000 & Over)	11,038,700	20.7	794	0.7
		53,530,285	100.0	110,581	100.0

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**Weeden Volume* consists of market-maker activity on regional exchanges plus Third Market volume. In our volume above, we have included our purchases as principal in addition to our sales as principal and agent, as we will when reporting all transactions on a common tape.

AMERICAN SECURITIES CORPORATION,
New York, N.Y.

SUBCOMMITTEE ON SECURITIES,
Committee on Banking, Housing and Urban Affairs,
U.S. Senate,
Washington, D.C.

I am H. Theodore Freeland, Vice Chairman of American Securities Corporation, New York City, New York. Our firm, established in 1946, is a member of the Pacific Stock Exchange, Detroit Stock Exchange and an Associate Member of the American Stock Exchange, with offices in New York, Boston, Chicago, Detroit, Grand Rapids, Hartford, Philadelphia and London, England.

We have maintained an active participation on the Third-Market since 1952. Our list of clients includes nearly all types of financial institutions, large and small, and both private and public Pension Funds. It is interesting to note that a very high percentage of our transactions takes place with clients acting in a fiduciary capacity.

We feel that competition in the securities industry is very much in the public interest. Over 10 years ago in its well-known Special Study the Securities and Exchange Commission came to the same conclusion and tried to improve communication between the markets by forcing an Amendment to the restrictive Rule 394 of the New York Stock Exchange. It is well known that this proved ineffective.

The Third-Market firms have always had a very active business with the Regional Exchanges, and at this time conduct a significant percentage of the business right on the trading floors of most of them. The "Multiple Trading Case of 1941" established the fact that the New York Stock Exchange does not have and should not have a monopoly in the trading of stocks on its floor. This decision established the right of New York Stock Exchange members to deal on Regional Exchanges in New York Stock Exchange listed securities. Certainly nothing has happened recently to change the situation under which the Regional Exchanges and the Third-Market working well together offer healthy competition. As a matter of fact, the public interest would best be served by increasing market-making capabilities rather than passing legislation which could tend to further restrict it. We feel that the Securities and Exchange Commission has been well aware of the activities of the Third-Market, and both Securities and Exchange Commission and Department of Justice have at their disposal adequate authority to protect the public interest when and if it appears that any group of firms or any Stock Exchange is engaging in improper practices. Therefore, we respectfully urge that the legislation not include provisions which would seem to discriminate against one market to the benefit of another. Legislation which might cause securities to be traded only on the New York Stock Exchange would be as prejudicial as legislation confining all trading to the Third-Market.

H. THEODORE FREELAND,
Vice-Chairman of the Board.

GOLDMAN, SACHS & CO.,
New York, N.Y., April 11, 1974.

Hon. HARRISON A. WILLIAMS, Jr.,
U.S. Senate, Russell Senate Office Building, Washington, D.C.

MY DEAR SENATOR WILLIAMS: I have had an opportunity to read the statement of Donald F. Weeden, Chairman of the Board of Weeden & Co., before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs on S. 3126, which he delivered on March 28, 1974. As you know Mr. Weeden made reference to myself and to stipulated testimony I gave in the *Thill* case where I said that I had changed my former views and was now of the opinion that the advent of fully negotiated commission rates would not be likely to cause Goldman, Sachs to leave the New York Stock Exchange. Mr. Weeden has taken my statement and presented it to you in support of his position that member firms will not leave the Exchange with the advent of negotiated rates.

I feel it is very important to inform you that Mr. Weeden's reference to my statement absent a proper analysis of what I know I meant by that statement is in my mind, most misleading. I am now and was at the time of the *Thill* case, and in accordance with the Martin Committee Report, greatly concerned about the preservation of the auction markets with the advent of negotiated rates so long as transactions in listed securities are permitted to occur off the exchanges. As a member of the Board of Directors of the New York Stock Exchange, I expressed this concern at our meeting in San Francisco when it was agreed that

the Exchange would adopt negotiated rates. I recently reiterated my position at the 7th Annual Institutional Investors Conference and also in a recent letter to Senator Hart, a copy of which letter I am enclosing here, along with the speech I gave at the Institutional Investors Conference.

Mr. Weeden's firm, having memberships on the Cincinnati Stock Exchange, the Detroit Stock Exchange and the Philadelphia-Washington-Baltimore Stock Exchange, certainly makes use of the auction markets. I find it difficult to accept his disabuse of the major exchanges and his failure to acknowledge their importance in our capital market structure. As I said earlier, I felt this response to Mr. Weeden was necessary for clarification of my own position. I am happy to have had this opportunity to do so.

Very truly yours,

GUSTAVE L. LEVY.

Senator BIDEN. Gentleman, thanks.

Mr. Paul Kolton, Chairman of the American Stock Exchange.

STATEMENT OF PAUL KOLTON, CHAIRMAN, AMERICAN STOCK EXCHANGE, ACCOMPANIED BY NORMAN S. POSER, SENIOR VICE PRESIDENT

Mr. KOLTON. Thank you very much.

In view of the lateness of the hour and the patience of the subcommittee, what I would like to do is enter our full statement into the record and hold ourselves available for any questions that you might have and because I was able to hear the previous testimony of Mr. Weeden, I would like to say also that the American Stock Exchange is an owner of SIAC and I am a director of it and I would like to request that the record be kept open as regards Mr. Weeden's comment on page 10 of his statement since, to my knowledge, that is so grossly without foundation that I think the subcommittee would be interested in having the specific information as to the significant work——

Senator BIDEN. If you can get whatever you have in mind within the weekend, we will get it in the record.

Mr. KOLTON. We can get that very quickly.

Senator BIDEN. Your entire statement will be reprinted in the record.

[Statement of Mr. Kolton and a subsequent letter received for the record follow:]

STATEMENT OF PAUL KOLTON, CHAIRMAN OF THE AMERICAN STOCK EXCHANGE, INC.

My name is Paul Kolton. I am Chairman of the Board of the American Stock Exchange, Inc. With me today is Norman S. Poser, Senior Vice President for Policy Planning and Government Relations.

We welcome this opportunity to make a statement in support of S. 3126, a bill which we regard as essential to help assure the preservation, for the public, of the nation's exchange markets. Further, we want to express our appreciation for the great foresight shown by the Subcommittee, in recognizing the clear dangers to the nation's exchange markets that are implicit in the change taking place as the securities industry moves towards competitive commission rates, and in taking the necessary steps to help avoid these dangers.

The move to fully competitive rates, scheduled for May 1975, is the culmination of a series of moves in this direction which began nearly six years ago—in May 1968, when the SEC opened its commission rate hearings. During the past several years a volume discount and negotiated rates have been instituted on the upper end of the commission scale, and next Monday, April 1, an experiment on the lower end of the scale will be inaugurated, introducing unfixed rates, for the first time, at the level of transactions typically involving public retail customers.

The thrust of this bill is to preserve the unique qualities of the existing

exchange auction markets which, alone in the world, have attracted wide public participation. As the Subcommittee, the SEC and others have recognized, these unique qualities are worth preserving. Their extraordinary liquidity and depth; their reliability in good times and bad; and the priority afforded to the public, in which the role of the professional is subordinated—all of these characteristics have created public confidence and participation in the exchange markets. Not only are the exchange markets widely recognized as the fairest, most efficient and most liquid in the world, but they have made the system of raising and allocating capital work—and in the process, that has made the economy work.

Up to the present time, these inherently desirable qualities of the exchange markets have been preserved by means of the fixed commission rate which, whatever its pros and cons, has bound brokerage firms to the exchanges and resulted in a flow of orders that gave the markets their responsiveness, their disclosure and their broad public participation.

Equally important, it is generally agreed—by the SEC, Professor James Lorie, this Subcommittee and its counterpart in the House—that the markets of the future—the proposed central market system—should have those important characteristics in which the public is protected by an effective regulatory and disclosure pattern, and in which the professional defers to the public.

We are, in a sense, prisoners of the calendar. A central market system is going to take a number of years to construct and implement, and S. 3126 recognizes the dangers of what might happen during the bridge period, between the advent of fully competitive commission rates and the establishment of the central market system.

Without the economic cement which fixed rates have heretofore provided, mandating as they did, that brokers bring their orders to the exchange markets, there is strong reason to be concerned that exchange member firms will find it in their own self-interest to give up their memberships and proceed in their offices to deal as principals with their customers, or to act as agents by crossing orders of buying and selling customers in their offices. This is not likely to happen suddenly or dramatically; rather, there is apt to be a gradual erosion of membership, followed by a drying up of the flow of orders to the exchanges, a cup at a time, coupled with a lessening of the exchange markets' characteristic liquidity.

As spreads and price variations widen, more transactions can be expected to move off board. With the dispersion of orders away from the exchange markets, and more dealer markets made in brokerage offices, the public investors' opportunity to obtain fair value in purchases and sales will necessarily be impaired. And, further, the public generally would not have any opportunity to participate in trades executed in brokerage firms' offices. This may be a heavy price for the public investor to pay for a commission rate schedule that is competitively arrived at—for the loss of even a small fraction of a point in the execution price will more than offset any likely savings in commissions to a customer.

A review of statements made by member firms and institutions at conferences which have been held in recent weeks around the country indicates what firms may do in their own self-interest, once fully competitive rates arrive. There is a growing consensus that dealer markets in listed securities will become of significantly greater, if not of primary, importance after April 1975. A number of brokerage firms have indicated that they are giving very careful consideration to operating in this new dealer environment. Some of these firms are fully aware of the unique benefits which the public derives from the auction market system—centralization, liquidity, disclosure, effectiveness of regulation—but they are equally aware that if the present exchange markets are weakened they will be forced to follow the trend into dealer markets. One informed observor has predicted that before the end of this decade more than 50% of agency transactions now handled on the exchanges will have shifted over to dealer markets.

Institutional investors too are concerned over possible weakening of the auction markets for listed securities. More than 80% of the institutions attending a recent conference were reported to be fearful that fully negotiated rates will signal a move to fragmented and illiquid dealer markets. In addition, foreign institutions have expressed concern over the possible impairment of the auction markets.

Thus, the dangers which S. 3126 seeks to avoid are by no means illusory. While no one can say with certainty that these results will occur, there is certainly evidence today that they are being considered. It is this consideration, in our view, that gives special urgency to the bill before the Subcommittee.

There are two specific points relating to S. 3126 which I would like to mention:

First, paragraph (3) of the bill provides that any rule promulgated by the SEC pursuant to it shall not become effective until the rules of national securities exchanges fixing commission rates have been eliminated. The SEC recently indicated that it would not now require the exchanges to remove fixed intra-member rates—that is, rates one member pays another for executing orders on the floor—during the 13-month limited experiment with negotiated rates which will begin next week. These rates, incidentally, represent only a small fraction of present public rates. The Commission has also indicated it plans to conduct a public inquiry on intra-member rate questions.

Since the question of intra-member rates is still to be decided, and to make the meaning of S. 3126 entirely clear, we would recommend that Section (3) be modified so that it states that no SEC rule shall become effective until "the rules of national securities exchanges fixing public rates of commission have been eliminated."

The second specific point which we would like to raise is our concern that, in the event it becomes necessary for the Commission to take action under the bill, the procedures which would need to be followed would be so time-consuming as to defeat the purpose of the bill. The findings which the Commission would be required to make would require the holding of hearings which could last a protracted period of time. Further, there would presumably be an opportunity for oral arguments before the Commission by interested parties, as well as judicial review. By the time these procedures have been completed, it is possible that the deterioration of the markets, which the bill is designed to prevent, will have occurred.

We recognize, of course, the importance of providing due process to those who might be affected by SEC action, and we do not suggest that the bill be changed to eliminate these procedural safeguards. However, we think it would be helpful if the Subcommittee's report accompanying the measure were to include a recognition of this problem, as well as an indication that it is the intent of Congress that the SEC act expeditiously in order to avoid the dangers to the markets which S. 3126 is intended to prevent.

Thank you.

AMERICAN STOCK EXCHANGE INC.,
New York, N.Y., April 8, 1974.

Hon. HARRISON A. WILLIAMS,
Chairman, Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR SENATOR WILLIAMS: During my appearance at the March 28 hearing on S. 3126. I said I would provide members of the Subcommittee with the facts regarding the work being done by the Securities Industry Automation Corporation (SIAC) to develop the consolidated tape system (CTS). This was prompted by a statement made by Mr. Donald E. Weeden at the hearing that "the word has gone out to slow up the computer research and program development and to resist all change and compromise on the consolidated tape . . ." (see p. 157). It is, therefore, requested that this letter be made part of the record of hearing on S. 3126.

It was during the first quarter of 1973 when SIAC, jointly owned by the Amex and the NYSE, formed a project team and the initial project plan was developed. SIAC then geared-up its organization to execute the consolidated tape project on the assumption that implementation of the plan would be forthcoming shortly. From April to July 1973, the SIAC effort accelerated to 11 people actually writing computer programs at a monthly cost of approximately $80,000.

In the summer of 1973, it became apparent that further work would have to be undertaken to finalize the plan. In the absence of any finite product specifications and the danger of having to redesign CTS to conform to the final version of the plan, the Amex, NYSE and SIAC agreed to reduce the level of effort on this program until such time as the outstanding issues had been resolved. Consequently, the monthly billed expenses for the project have averaged approximately $25,000 since August 1973. These costs are expected to rise shortly to a total of $78,000 a month.

Significant progress has been made to date on the SIAC project to prepare the necessary computer and other technical programs to implement a final con-

solidated tape plan. The project is on schedule with completion targeted for December 1, 1974, at a projected total cost of $1,073,000 of which $513,000 had already been expended by the end of February 1974.

In conclusion, I want to assure the Subcommittee that Mr. Weeden's statement notwithstanding, SIAC is proceeding diligently in developing CTS and its work will accelerate in the coming months.

Sincerely,

PAUL KOLTON,
Chairman.

Mr. KOLTON. As to Mr. Weeden's comments, over $500,000 has already been spent on development of the composite tape by the American and New York Stock Exchanges.

What he may be referring to is that after major expenditures had been made and development work completed, late last year, and when the startup date on the composite tape was in question, certain expenses were cut back so that the programs were maintained, but the level of expenditure was reduced until we had a firmer fix on the starting date.

But his statement, as I say, is so without foundation, I think the record should be corrected.

Beyond that, I would like to say very briefly that the American Exchange speaks from a particular point of view and that is the fact that it is the market that primarily serves the individual public investor.

We feel very strongly that the subcommittee has identified certain clear dangers to the exchange markets that might arise. We are not at all sure that they will, but they might arise in view of the changes that are taking place in the industry and we think, in those terms, that S. 3126 is a constructive and a necessary step.

I think beyond that, we really are in a sense prisoners of the calendar. A central market system is coming; it will take, however, a number of years to construct and to implement and I think that what S. 3126 recognizes is the danger of what might happen during the period between the end of fixed commissions and until a central market system is in place, S. 3126 seeks to deal with this problem period in as effective a way as possible.

I mighty say, too, that there has been a great deal of discussion about the possible erosion of membership. I believe from recent conversations by member firms and by institutions around the country that that is certainly something that they are thinking about.

I think that if that erosion takes place, it won't happen suddenly or dramatically but it will be a gradual process, a slow drying up of these markets, and a lessening of the characteristic liquidity that the markets have demonstrated.

So, given all of those factors, we would like to commend the subcommittee and hope that S. 3126 which points to dangers which we don't think are illusory by any means, and which has been designed to meet those dangers, is approved.

Beyond that, Senator, there are two very brief comments I would like to make that are of a more technical nature as regards S. 3126.

One is that the timetable for ending fixed commissions 13 months from now does not come to grips with the fact that intramember rates which are to remain fixed for the immediate present still represents an open issue.

We would like to recommend, very briefly, that since the SEC has indicated it will hold hearings on the intramember rate question that section (3) be modified so that it states that no SEC rule shall become effective until the rules of national securities exchanges fixing public rates of commission have been eliminated. That would provide opportunity for the SEC's hearings on intramember rates.

The second point that we want to mention——

Senator BIDEN. You are referring to section 3 of S. 3126.

Mr. KOLTON. Yes.

The final point is to express a concern that if it becomes necessary for the Commission to take action under this bill, the procedures which would need to be followed are likely to be very time consuming. They are apt to be so time consuming perhaps as to defeat the purpose of the bill.

The Commission will be required to make findings. It will be required to hold hearings. And further, there would presumably be opportunity for oral argument and for judicial review.

By the time these procedures have been completed, it is possible that the deterioration, which people have identified as a possibility and which the bill is designed to prevent, will have occurred.

We recognize the importance of providing these due process steps and we don't suggest the bill be changed to eliminate any of these safeguards. But we do think it would be helpful if the subcommittee's report accompanying the measure were to include a recognition of this problem as well as an indication that it is the intent of the Congress that the SEC act expeditiously in order to avoid the dangers which S. 3126 has identified.

Thank you, sir.

Senator BIDEN. Gentlemen, thank you very much, particularly for the waiting until almost 8 o'clock to testify.

We should acquiesce in your suggestion just by the mere fact you waited this long. But I am afraid that is not likely to happen.

We appreciate your waiting, as I said, and your statement will be printed in the record. We will look forward to receiving in the next week or two to receiving your statement regarding the accusations made in the prior testimony.

Mr. KOLTON. Thank you very much.

Senator BIDDEN. Thank you very much.

The committee will be in recess at the call of the Chair.

[Whereupon, at 8 p.m., the hearing was adjourned.]

APPENDIX

Additional Statements and Data

Arizona State University,
Tempe, Ariz., April 2, 1974.

Hon. Harrison A. Williams, Jr.,
Chairman, Subcommittee on Securities, Senate Banking Committee, New Senate Office Building, Washington, D.C.

Dear Mr. Chairman: I am writing to offer some observations and suggestions on S. 3126, which would require the Securities and Exchange Commission, under specified conditions, to prohibit trading of listed securities otherwise than on a registered securities exchange. Having had the honor to serve as Chief Counsel to your Subcommittee in connection with its recent study of the securites industry, I am concerned that the well-considered and forward-looking recommendations which the Subcommittee unanimously approved as a result of that study may become casualties of the near-panic which seems to afflict the members of the New York Stock Exchange as they approach closer to the day on which the fixing of commissions on exchange transactions will end.

Having had the opportunity to read the statements and listen to some of the testimony submitted in connection with your Subcommittee's consideration of S. 3126, I can only observe that they seem to suffer from the same failure to define terms that always seems to attend the discussion of this inflammatory issue. If I may, therefore, I should like to set forth what I believe to be the real interests at stake, the significant dangers to those interests, and what the Subcommittee might usefully do to preserve them.

The argument underlying the approach of S. 3126 is that the introduction of competitive rates on exchanges will reduce or eliminate the incentive to bring transactions to those exchanges, and that an increasing proportion of transactions in listed securities will flow into the over-the-counter markets, with resulting detriment to members of the investing public. It is important, therefore, to set forth precisely what benefits public investors derive from having transactions executed on exchanges, and, second, precisely how those interests are likely to be adversely affected by the introduction of competitive rates.

As your study recognized, there are two important advantages that individual investors enjoy when they trade on an exchange, rather than an over-the-counter, market.

The first, and most significant, advantage is that the broker who acts for the customer in executing a transaction is not usually engaged at the same time in dealing in that security as principal for its own account. This separation of "broker" and "dealer" functions eliminates a conflict of interest which has been at the root of many abuses in the over-the-counter markets. It helps to assure that a customer's order will be executed at the best price available, whether represented by a dealer's quote or by the order of another public customer, and eliminates the incentive for a broker to recommend securities to customers which the broker wishes to unload from its own inventory.

The second advantage of an exchange market is that a customer can leave a limit order on the specialist's book on an exchange and be assured that his order will be given priority if the security is traded at that price on that exchange. This capability may serve as a significant incentive in bringing individual public orders into the market, thus improving liquidity, and was recognized by the Subcommittee in its Report as an advantage that should be preserved in the movement toward development of a central market system.

In what way will the introduction of competitive rates on exchange transactions affect these advantages which investors currently enjoy in the exchange markets? First, it should be noted that the remedy proposed in S. 3126 would prohibit *all* trading in the "third market"—the over-the-counter market in listed securities. Yet there is not a shred of evidence that the introduction of competitive rates will divert any business to the firms which presently constitute the third market; indeed, the effect should be exactly the opposite. The third de-

veloped to serve the needs of nonmember brokers and institutions which were unable or unwilling to pay the artificially high fixed commissions required to effect their transactions on an exchange. If the introduction of competive rates serves its intended purpose of bringing brokerage charges on various classes of transactions more in line with the costs of those transactions, the only logical expectation would be that the flow of business to the third market would decrease, and might even dry up altogether.

The significant danger, then, is not that business will flow to the third market, as presently constituted. The danger is that many of the retail brokerage firms which are currently exchange members will relinquish their exchange memberships and conduct integrated broker-dealer activities in listed stocks in the over-the-counter market, dealing with retail customers as principal. It is difficult to determine in advance how real a possibility that is. Nevertheless, it cannot be dismissed as chimerical. It is at least conceivable that one or more large retail firms would decide that it was economically advantageous to leave the exchanges and conduct business solely in the over-the-counter markets, where their trading profits as principal could augment the commission income they receive as brokers for their customers. This development in turn could trigger a wholesale exodus from the exchange markets. Such an event might, in the long run, prove to be a benefit to the investing public, but it is clear that your Subcommittee, in strongly urging the elimination of fixed rates, did not intend the demise of exchange markets as an immediate sequel. It is therefore completely appropriate for the Subcommittee to take steps to assure that the ending of fixed rates does not produce an immediate and unintended restructuring of the entire retail market for listed securities.

The problem with S. 3126 is that it confuses this entirely legitimate objective with the long-standing NYSE objective of eliminating all competition with the markets being made by the specialists on the NYSE floor. Fortunately, there is an alternative method by which the flight from the exchanges could be prevented without at the same time eliminating the present third market—indeed without requiring any significant changes in the way any securities firms presently conduct their business.

My suggestion is that the Exchange Act be amended to prohibit any broker-dealer which effects transactions in listed securities with or for any person other than a broker, dealer or institution from effecting any transactions in such security for its own account as principal, except as permitted by rules which the SEC would be authorized to promulgate. The effect of this amendment would be to prevent the firms which do a retail business in listed securities from becoming integrated retailers and market-makers in those securities. There would therefore be no incentive for them to direct the flow of retail orders away from the markets in which they are presently concentrated. At the same time, it would not significantly affect the operations of third-market firms, which by and large do business only with brokers, dealers and institutions. Nor should it significantly affect the operation of exchange specialists, who generally deal only with brokers, or exchange members engaged in block positioning, who by and large deal only with institutions in their block positioning activities. The rule-making power given to the SEC would permit exemptions to accommodate the legitimate activities of certain specialist, block positioners, third market makers and others who could not effect a complete separation of functions.

The amendment I am proposing also happens to be one which your Subcommittee suggested in its Report last year to meet precisely the arguments which the members of the NYSE are now making. At page 122 of that Report, your Subcommittee stated that "to meet this legitimate concern raised by the NYSE [that retail customers would be deprived of the protection of agency representation on transactions in listed securities], the Subcommittee will consider the desirability of legislation to prohibit market makers in listed securities from dealing directly with individual members of the public in those securities. . . ."

The proposed amendment would also have the advantage of not putting the SEC into a position where it would be forced to make a major policy decision on inter-market competition under conditions of extreme pressure and with no clear standards to guide its decision. The dangers to the SEC in this kind of situation are not just a matter for speculation. In the course of your Subcommittee's general study of the securities industry, you did a detailed case study of the SEC's actions in a very similar situation—the decision on the inclusion in the NASDAQ quotation system of third market quotes in listed securities. In that case, the SEC (and the NASD) were under extreme and continuous pressure from the New York and American Stock Exchange to prohibit the inclusion of listed

securities in NASDAQ, on the ground that it would be "inimical to the interests of investors and the concept of a central marketplace" and that it had the "potential of serious and accelerated erosion of regulatory standards for listed securities." After reversing their field several times, the SEC and the NASD finally resisted this pressure and authorized the inclusion of certain listed securities in NASDAQ on a "test basis". After a three-month test, the "fears" which the exchanges had expressed proved to be unfounded. The NASD found that inclusion of listed securities in NASDAQ had "no deleterious effects on the general market structure" and that "the high degree of competition between NASDAQ and exchange quotations has had a small but significant effect in reducing dealer spreads for issues included in NASDAQ."

I do not mean to suggest that the Commission is unable to stand up to industry pressure and reach an honest decision on the merits of an important issue. Indeed, the expertise and integrity of the Commission's membership is perhaps at the highest point in the agency's 40-year history. What I am afraid of is that, given the way S. 3126 is structured, the Commission will be "praised if it does, and damned if it doesn't." It will have no effective choice but to use the meat-ax the Congress has handed it and chop off the head of the third market. I do not believe that an honest and diligent regulatory agency should be placed in this sort of position, particularly where there is available to the Congress a much simpler and more direct method to deal with the problem with which the members of the New York Stock Exchange purport to be concerned.

I have taken the liberty of sending copies of this letter to the other members of your Subcommittee, to the members of the Securities and Exchange Commission, and to other persons interested in the resolution of this important issue.

Sincerely,

DAVID L. RATNER.

[From the New York Times editorial page, Mar. 27, 1974]

COMPETING FOR SECURITIES

Just when it seemed to be moving into the clear, the drive to promote open competition in the nation's securities markets is running into new resistance on Capitol Hill. Early this month the Senate Banking Committee unanimously approved comprehensive reform legislation to create a national central market system and eliminate fixed commission rates and other long-enshrined anticompetitive practices. But floor action is now stalled pending consideration of a related measure which could give a Federal regulatory agency the authority to close down the so-called third market, the increasingly popular facility for trading listed stocks off the exchanges.

To New Jersey Senator Harrison Williams, sponsor of the new bill, all that is intended is an interim "fail-safe" provision to insure that shareholders do not suffer from a breakdown of fair and orderly markets during the transition into the central market several years hence.

The measure's opponents, including Senator Philip Hart of Michigan, argue that this seemingly innocuous provision has the potential of becoming a Trojan horse—one that could allow the major stock exchanges to halt the ongoing reform process. It could open the way for years of litigation and filibuster before a pliable Securities and Exchange Commission, while the established exchanges reassert monopoly control over how securities are traded and by whom.

Years of futile efforts to open the clubby and restrictive atmosphere of Wall Street's auction markets to freer competition and technological change breed suspicion of any attempt to inhibit the long needed reforms now finally in process. The Williams bill would supposedly guard against a liquidity crisis—but the only warnings of such a crisis come from the stock exchanges themselves, the very institutions whose position might be threatened by the move to free competition.

Caution is unquestionably justified in delegating broad new powers of judgment to a Federal agency with demonstrable and long-standing ties to the exchange establishment. Though the present chairman of the S. E. C., Ray Garrett, Jr., has taken a bold stand in promoting anticompetitive reform, this was not always true of his predecessors and it may not survive his tenure.

The Wall Street community is understandably nervous about the imponderables in competitive operations, which are bound to undermine many of the hallowed and comfortable practices of past generations of brokers.

But the interest of the shareholding public would be ill served if the Congress, under guise of an interim technical safety valve, opened the way to restoration of monopoly practices in the securities industry.

STATEMENT OF FRANCIS C. FARWELL, PARTNER, WILLIAM BLAIR & CO.

My name is Francis C. Farwell. I am a partner in the investment banking firm of William Blair and Company in Chicago. Our firm is a member of all major stock exchanges and, in addition to its investment banking activities, does an institutional and individual customer business nationally and internationally. I am currently Chairman of the Midwest Stock Exchange. However, the views I present today are my own and not necessarily the views of my firm, nor the Midwest Stock Exchange.

My comments are directed to the subject matter that is addressed by the Bill, not the Bill itself in its present wording. The major task for our industry, over the foreseeable future, is to provide the mechanism for raising the capital needed by this country to accomplish its goals. The numbers are enormous by all present estimates.

In order to provide this investment banking function, the raising of new capital, it must be recognized that the sources of that new capital will be interested only if they have a reasonable expectation of liquidity. Unquestionably, one of the greatest strengths of the capital-raising mechanism in the United States has been the broad liquidity which has existed in the secondary markets; i.e., the markets after the initial underwriting. That liquidity is provided, in respect of the listed sector, mainly by the exchange markets, but it is also provided to a significant degree by the third market.

In the exchange markets, liquidity is provided through the auction process in which there is maximum opportunity for public orders to meet, and also through the dealer function of specialists and block positioners. The need for the dealer function will continue to grow if our markets are to provide the element of liquidity that investors expect. But the recognition of the need for the dealer function must be balanced by a recognition of the importance of an efficient auction mechanism in which public orders meet without dealer involvement as often as possible and in which there is appropriate protection and preference for public transactions.

The investment banking function also requires large capital resources. There must be sufficient confidence in the strength of our exchange markets and the ability of professionals to operate profitably in those markets so that present resources of the industry will not be further eroded and new resources will be attracted.

Based on these views, I believe that the market-making capacity of the exchange markets and of the third market must both be preserved and fostered as a matter of public policy; accordingly I am not here to request that anybody be legislated out of business, nor unduly or haphazardly regulated. I also believe that the legislation which this Committee has already acted upon related to the Central Market System of the future, with its stress-on competition, will create opportunities for the liquidity of the marketplace to improve. However, in the light of the economic and regulatory changes that are presently taking place or foreseeable, I believe there may be changes in the incentives and disincentives relating to various functions that would bring about still other changes not now foreseen.

It is my belief and hope that the characteristics of the exchange markets and the third market can and will be melded in the future in such a way as to give the resources presently involved in both markets an opportunity to perform, to grow, and to compete with one another; and it would be my hope that the power granted in this legislation would never be needed. However, if I am wrong in my judgment, the stakes are high and I feel that it would be prudent to give the SEC the power to act, and to act swiftly, in preserving the exchange markets. I do not believe that the SEC would misuse that power in any way and that it would take into consideration not only the securities laws, but the antitrust laws as well in exercising that power.

On a purely practical level, I believe the existence of such power within the hands of the SEC will do much to provide a measure of reassurance to some in the industry and to strengthen the hand of those who share my beliefs as to the desirability of moving effectively to bring about the melding of these markets.

We must recognize that there are many who fear change but who must be a part of the change if it is ever to be truly effective.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., May 8, 1974.

Hon. HARRISON A. WILLIAMS, Jr.,
Chairman, Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR SENATOR WILLIAMS: On March 27, 1974, Chairman Garrett appeared with the full Commission before your Subcommittee to testify on S. 3126, a bill to grant the Commission authority, in certain circumstances, to confine trading in listed securities to national securities exchanges. In your prepared opening statement at those hearings you stated that "the balance between competition and investor protection with respect to the third market is out of whack" and that "the time has come for the third market to be regulated a little more equally." You specifically mentioned three regulatory areas as examples of the proposition that "matters have gone askew."

(1) *Disclosure.* Transactions in the third market are not publicly reported "nor are all third market quotations available for public scrutiny."

(2) *Short Sale Regulation.* Third market makers are not subject to short sale regulation.

(3) *Regulation of Dealers.* Third market dealers are not subject to "anti-manipulative rules of anywhere near the stringency of those under which the specialists operate . . . have no obligation to honor public limit orders . . . are not even required to trade in a manner consistent with the maintenance of an orderly market . . . [and] can enter or leave the market at will."

At the same time, you requested that the Commission report to you any developments with respect to regulation of the over-the-counter market in listed securities (the so-called "third market"). In the absence of Chairman Garrett I am responding for the Commission to that request.

* * * * * * *

Concern has been expressed by the New York Stock Exchange, Inc. ("NYSE") and others that during the interim period after implementation of fully competitive commission rates, currently scheduled to become an effective April 30, 1975, and before the establishment of a central market system, such as that envisioned by the Commission in its *Policy Statement on the Structure of a Central Market System* ("Policy Statement"),[1] continued over-the-counter trading in exchange-listed securities, the "third market", may present a grave threat to the auction trading process on exchanges, particularly since third market participants are not currently subject to the same degree of regulation as are exchange members. It has been suggested that the absence of "equal regulation" of the third market will constitute an incentive for exchange members to abandon their memberships and conduct their activities in the third market, an argument which the Chairman addressed in his letter to you dated December 10, 1973. This fear of market disruption occasioned by a potential mass exodus of exchange members to the third market led to the introduction of S. 3126 and presumably to your concern about the "inequality" of regulation between exchange markets and the third market.

The asserted necessity for "equal or uniform" regulation has been a proposition debated for some years now. Often it has been a debate which has obscured rather than enlightened. We appreciate the opportunity therefore to discuss our thoughts and positions with you in some depth.

Exchange market places and over-the-counter markets have long had different characteristics. The over-the-counter market in listed securities in particular has shared few characteristics with exchange markets historically except that both, by definition, trade in the same securities.[2] Your opening remarks indicate a view that the only reason the Commission has not imposed "equal regulation" on the third market is in order to nurture the competition such market provides to the specialists on the primary exchanges. That is not so.

The fact that the third market performs a useful function, competitive or otherwise,

> "does not, of course, lessen the public interest in its operations, an interest which extends to all markets for the trading of securities. It is important

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[1] *See*, Securities and Exchange Commission, *Policy Statement on the Structure of a Central Market System* (Mar. 29, 1973).

[2] *See* 2 Securities and Exchange Commission, *Report of Special Study of Securities Markets*, H. Doc. No. 95, 88th Cong., 1st Sess. 870–911 (1963) (*"Special Study"*).

that the off-board market for listed securities, taken both independently and in its relationship to other markets, operate to achieve the objectives of the Exchange Act." [3]

The Commission would be remiss in discharging its function to provide the necessary protections to public investors were it to ignore clear regulatory needs for the purpose of fostering the growth of the third market. On the other hand, the Commission would be equally remiss were it to cast exchange markets and the third market in the same Procrustean mold purely to serve symetry. As the Commission's *Special Study* put it, the

"[t]ransfer to market makers on the third market of any regulations governing the activity of the primary market makers generally . . . should depend on the applicability of these regulations to the special facts of the third market.

"Similarly, the inherent differences between the off-board market and the exchange markets preclude their being placed in the same mold. Regulations are not to be transferred from one to the other in the name of uniformity." [4]

The principles expressed in the Commission's 1963 *Special Study* quoted above, while still valid, were of course pronounced in the context of competition between exchange markets and the third market as we have traditionally known it. The planned implementation of a central market system, however, introduces a new factor which must be considered carefully in balancing differences in the regulatory framework governing such competitors.

In a central market system, investors will be able to leave an order with a broker who will have access to a communications system enabling instantaneous determination of the best bid and offer in all markets. The broker may find that the best market is on the primary market, on one of several regional exchanges or in the third market. Thus, competition among market makers and specialists in listed securities for customer's orders will be based, to an even greater degree than today, on the ability of a market maker to offer the best bid or offer. Artificial constraints on, and economic disincentives to, taking orders to any particular market place will be removed. Moreover, third market makers themselves will have greater access than today to the prevailing primary markets, where the great majority of trading in listed securities currently occurs. It is in connection with this process of integrating third market dealers into the central market system, where competition will not be distorted by artifical influences and where markets will no longer be compartmentalized and fragmented by regulatory and economic dissimilarities, that it will be important to devise and subject third market firms "to appropriate market responsibilities and other regulatory requirements commensurate with the benefits they may realize." [5] In this environment, it will be the expectation of customers that wherever their order is executed in the system, on a primary exchange, regional exchange or with a third market maker, their order will be treated fairly and in accordance with certain fundamental principles governing the system as a whole.

As you recognized in your opening statement at the hearings on S. 3126, the delicate nature of this balancing process requires a substantive and sensitive appraisal of the proposed regulatory framework within which such competition should operate. This appraisal must include (1) the role and function each classification of market maker in listed securities performs; (2) the inherent or peculiar characteristics each type of market maker retains, even after integration into the central market system; (3) the need for re-examination of regulation in the primary market, such as that governing specialists, to determine whether competition may perform a similar function in a more effective way; and (4) the need to identify those common characteristics and trading functions which should be regulated in a fair and uniform manner. In this respect, we believe the Commission and the Subcommittee have been in substantial agreement. For example, the *Interim Report* of your Subcommittee stated:

"Equal regulation of dealers is clearly appropriate, provided that the phrase is understood to mean that dealers enjoying similar privileges, performing similar functions and having the potential for similar market

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[3] *Id.* at 908. For example, "[i]t would be difficult to justify differences in trading practices and operation, if any should develop, which may merely serve as loopholes in exchange regulation." *Id.* at 909.

[4] *Id.* at 908–909.

[5] Securities and Exchange Commission, *Statement on the Future Structure of the Securities Markets* 9 (G.P.O. ed. 1972).

impact are treated equally. Regulation is to be imposed only when the public interest and the protection of investors requires it—never for its own sake. The call for 'equal regulation' is no guide for regulatory action, unless it is first determined who is equally situated in terms of the purposes of the regulation." [6]

The final Report of your Subcommittee also recognized that certain market makers perform different functions and that regulation must take those functions into account:

"The regional exchange specialists, third market-makers and block positioners have been operating as alternative market-makers for some time now, each operating in a distinctive manner to meet particular market needs." [7]

"With respect to the manner in which different groups of market makers should be regulated, the Subcommittee believes that the purpose of integrating them into a single system is not to make all of them do business in the same way, but rather to enable public investors to take fuller advantage of the distinctive contributions that each can make. For example, the particular restrictions placed on specialists in view of their management of the 'book' of public orders, such as the prohibitions against their dealing with institutions, are not necessarily applicable to other types of market makers, who generally deal directly with institutions and do not handle orders of individual members of the public." [8]

The Commission concurs with the principles articulated in these reports, principles which call for an understanding of the various privileges and advantages that market markers in some markets have over others and of the varying degrees of need for certain forms of regulation as between the primary market for a security and secondary markets. If there has been a difference between the Subcommittee and the Commission in this regard, it has been minor: the Subcommittee stated it preferred gaining experience with the operation of the central market system before determining how participants, particularly the market makers, should be regulated,[9] whereas the Commission, while in agreement with the Subcommittee that it would be unwise to impose an elaborate regulatory framework on market makers prior to experience with the pattern of trading which emerges,[10] has believed it could identify in advance certain areas where appropriate regulation could be proposed, and perhaps adopted, before such experience is gained.[11]

Indeed, two of the areas you have inquired about, uniform disclosure of transaction information and uniform regulation of short sales, have been identified by the Commission, in its *Policy Statement*, as appropriate for uniform treatment.[12]

We believe it is appropriate to respond in some depth to the specific areas cited in your opening remarks on S. 3126 as examples of the proposition that the third market needs to be regulated more equally.

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[6] Subcommittee on Securities, Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess., *Securities Industry Study Report* at 43 (1972) (*"Senate Interim Report"*).

[7] Subcommittee on Securities, Senate Committee on Banking Housing and Urban Affairs, 93d Cong., 1st Sess., *Securities Industry Study*, S. Doc. No. 93–13, 116 (1973) (*"Senate Report"*).

[8] *Id.* at 12–13. *See also* Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 92d Cong., 2d Sess., *Securities Industry Study*, at p. 129 (Comm. Print, 1972).

[9] *See Senate Report, supra* n. 7, at 117. The Subcommittee's *Interim Report* also stated: "The first order of business should be the achievement of a system of competitive market makers. The time to determine how the participants in a truly competitive system should be regulated is after this has been done and the configurations of a functioning competitive system are clear. Competition, in this case, must come before the regulatory questions can be answered, for until there is actual experience with a competitive system the regulatory needs cannot be known."

Senate Interim Report, supra n. 6, at 43.

[10] *See Policy Statement, supra* n. 1, at p. 34 and n. 39.

[11] *Id.* at 31–35.

[12] *Id.* At 31–32. Nevertheless, it is one thing to say that all transactions in listed securities wherever they occur should be reported on a composite transaction reporting system and that all short sales which are reported in, and nationally disseminated through, that composite system should be regulated—a proposition we believe is valid; it is quite another thing to say that, absent a composite tape and uniform short sale rule, the third market has an undue competitive advantage over the primary market—a proposition we believe is questionable.

(a) Historical Trade Information

The primary exchanges have reported last sale information on a transaction tape for many years. In contrast, third market transactions have been reported to the public only on an aggregate, delayed basis.[13] Representatives of the exchange community have asserted that the "privacy" of third market trades has given the third market a competitive advantage.[14] Representatives of the third market, on the other hand, have asserted that this lack of reporting has been a competitive disadvantage.[15] It is not necessary, however, to become entangled in this debate.

As you are aware, on March 2, 1973 representatives of the New York, American, Pacific, PBW and Midwest Stock Exchanges and the NASD filed a joint plan, pursuant to Securities Exchange Act Rule 17a–15, which provides for the consolidated reporting of all transactions effected by broker-dealers in listed securities wherever they may occur.[16] On June 13, 1973 [17] and March 8, 1974 [18] the Commission made extensive comments to the sponsors of the plan on various of its aspects. On April 22, 1974 [19] that plan was refiled with the Commission. Within a short period of time we expect to declare the plan effective in its present form. As you are undoubtedly aware, the timetable of that plan calls for the implementation of a pilot project 20 weeks from the date the Commission delares the plan effective and for full implementation 40 weeks from the effective date.

(b) Quotations

The primary exchanges have asserted a "proprietary right" over the quotations of their specialists [20] and have historically prevented their dissemination to any but their members. In contrast, certain third market makers disclose their quotations in 108 listed securities in the National Association of Securities Dealer's Automated Quotation System ("NASDAQ"). As you are aware, in the past the primary exchanges have argued that third market makers should not be permitted to quote listed securities in NASDAQ,[21] a position that seems to belie the argument that non-disclosure of quotations by third market makers, to the extent it occurs, is somehow a competitive advantage. Moveover, many third market dealers are listed in the National Quotation Bureau "Pink Sheets".[22] Any broker-dealer or institution may telephone a third market maker

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[13] Securities Exchange Act Rule 17a–9 requires broker-dealers making off-board markets in equity securities listed on a national securities exchange to make quarterly reports of their total third market sales, their exchange purchases and sales of stock in which they make markets and their principal sales or agency purchases of other listed stocks (excluding transactions with other market makers). Summaries of total third market activity and a breakdown of third market activity in fifty selected stocks are published by the Commission quarterly in its *Statistical Bulletin*.

[14] *See*, Statement of the New York Stock Exchange, *Securities and Exchange Commission Hearings on Structure of the Securities Markets*, File No. S4–147, at 34–35 and 55 (Oct. 18, 1971) ; Statement of the American Stock Exchange, *Securities and Exchange Commission Hearings on Structure of the Securities Markets*, File No. S4–147, at 14–15 (Oct. 18, 1971).

[15] Statement of Investors Diversified Services, Inc. and Jefferies & Company, Inc., *Securities and Exchange Commission Hearings on Structure of the Securities Markets*, File No. S4–147, at 92–93 (Oct. 19, 1971). Four competitive factors were enumerated to support the contention that "third market firms thrive not on secrecy but on competition, and competition thrives on the availability of full information to all participants in the market." *Id.* First, information, leads to inquiry which leads to business. Second, reporting leads to credibility and adds legitimacy to a firm's execution. Third, the "printing" of a block executed at a discount serves as "advertising" for the broker who positioned a portion of the block. Fourth, third market firms are unable to execute trades outside the range of the tape even though the price may be appropriate, whereas, the same bid made by a member firm would be accepted because the report of the transaction would itself establish a new range. *Id. See also* 4 Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 92–64, 92d Cong., 1st Sess. at 1626, 1823, 2257, (1971).

[16] Securities Exchange Act Release No. 9850 (Nov. 8, 1972).

[17] Securities Exchange Act Release No. 10218 (June 13, 1973).

[18] Securities Exchange Act Release No. 10671 (Mar. 8, 1974).

[19] Securities Exchange Act Release No. 10760 (Apr. 26, 1974).

[20] Letter from American Stock Exchange to Mr. Ronald F. Hunt, Secretary, Securities and Exchange Commission, May 22, 1972 at 4 ; Letter from New York Stock Exchange to Mr. Ronald F. Hunt, Secretary, Securities and Exchange Commission, May 22, 1972 at 7. Both the NYSE and AMEX have rules which prohibit their members from publishing quotations for listed securities in an interdealer quotation system. NYSE Rule 438 ; AMEX Rule 482. *See also Senate Report, supra* n. 7, at 122.

[21] *Senate Report, supra* n. 7, at 117.

[22] Third market dealers are listed by name in the Pink Sheets. It is the informal policy of the National Quotation Bureau not to print actual quotations for listed securities, however, because they believe that such quotes may conflict with last sale reports on exchange transaction tapes, confusing investors.

directly and receive a quotation over the telephone. It is impossible for a nonmember similarly to call a primary market specialist for a quote. Thus, third market quotations are available to all broker-dealers and many customers; specialists quotations are not.

In any event, the Commission has made clear that a composite quotation system, will be the communications foundation on which the central market system will rest.[23] We expect to republish proposed Rule 17a–14,[24] which provides for the disclosure of quotations in listed securities from all markets, in the near future.

SHORT SALE REGULATION

Short selling practices on the primary stock exchanges have been regulated by Securities Exchange Act Rule 10a–1 since 1938.[25] Short selling in the third market has not been so regulated, primarily because such trading has not presented the regulatory problem that exchange short selling has presented.[26] Nevertheless, the Commission believes it important to establish a comprehensive short sale rule to regulate all transactions in listed securities reported on a composite transaction reporting system in order to preserve the integrity of that system.[27] On March 6, 1974, the Commission published for comment amendments to Securities Exchange Act Rules 3b–3, 10a–1 and 10a–2 which would prohibit the short sale by any person, including third market markers, of any listed security reported pursuant to an effective Rule 17a–15 plan below the price at which the last sale of such security was reported (a "minus tick") or at that price if the preceding transaction in such security was above the last sale price (a "zero minus tick").[28]

REGULATION OF DEALERS

The third area cited in connection with your opening remarks is the regulatory framework within which specialists and third market makers perform their functions. In those remarks you specifically addressed (1) anti-manipulative rules, (2) the obligation of specialists to honor public limit orders and execute customer's orders ahead of orders for their own account, (3) the obligation of specialists to trade in a manner consistent with the maintenance of a fair and orderly market and (4) the ability of third market makers to enter or leave the market at will. It would appear that you are suggesting the adoption of "equal or uniform" regulation in these areas now, before any experience with the "configurations of a functioning competitive system" [29] and indeed whether or not any further steps are taken to implement a national central market system in listed securities.

Through the stock allocation procedure, the primary market specialist is granted an exclusive "franchise" in his specialty stock, at least to the extent that orders are brought to the primary market.[30] Inherent in this franchise is (1) the ability to exercise a significant influence on the public appraisal of the price of an issuer's securities; [31] (2) an informational advantage resulting from the specialist's position at the center of trading activity in his specialty securities and from his knowledge of limit order interest stored in the "book"; [32] (3) a proximity advantage shared with all floor members which enables the specialist to react quickly to developments affecting the market; [33] and (4) an acute con-

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[23] Securities and Exchange Commission, *Statement on the Future Structure of the Securities Markets* 8–10 (Feb. 2, 1972).

[24] Securities Exchange Act Release No. 9529 (Mar. 8, 1972).

[25] *See generally*, 2 *Special Study*, *supra* n. 2, at 251–252.

[26] Short sales in a primary market, as opposed to a secondary market, may exhaust the only significant limit bid support in the particular security. Third market makers, on the other hand, generally do not hold a significant number of limit orders. In addition, without the "advertising" provided by a nationally disseminated last sale transaction tape, short sales in the third market would not influence others to sell. Similarly, without arbitrage it would be difficult to manipulate the primary market price indirectly by short sales to a third market maker since the securities sold to the third market maker may never reach the primary exchange market. A market maker would normally prefer to buy from and sell to his customer rather than lay off his position in another market since laying off may mean giving up part of the "jobber's turn" and incurring an execution expense.

[27] *Policy Statement*, *supra* n. 1, at 32.

[28] Securities Exchange Act Release No. 10668 (Mar. 6, 1974).

[29] *See* n. 8, *supra*.

[30] The exclusivity of this franchise has been eroded over the recent decade by block positioning firms, but still represents a valuable and unique privilege.

[31] 2 *Special Study*, *supra* n. 3, at 59.

[32] *Id.* at 59, 74–76.

[33] *Cf. id.* at 211.

flict of interest in representing customer orders as subagent for other brokers while at the same time trading from inventory, potentially competing with, or trading against, the customer.[34]

Over the years since the passage of the Securities Exchange Act[35] the exchanges have adopted numerous rules designed to prevent abuse of the unique advantages and conflicts in the specialist's position. These include, as you have mentioned, rules to curtail manupulative conduct, to regulate the specialist's function as broker and to limit his dealings to those transactions necessary to maintain a fair and orderly market. In addition, in 1964 the primary exchanges were required for the first time to incorporate an "affirmative" obligation in their rules, requiring that a specialist provide not only continuity but also depth.[36]

In comparing regulation governing the specialists' activities with regulation, or lack thereof, governing third market activities, it is important to bear in mond the privileges inherent in the former's position, since it is these privileges which have often been the *quid pro quo* for the requirement that a specialist contribute to a fair and orderly market on a continuous basis. For example, the *Special Study* stated that the only justification for permitting the specialist exclusive knowledge of orders on the book, "a definite trading advantage", is "the benefits which the specialist confers on the market and only if high standards of conduct in dealer and broker activities are defined and enforced."[37]

It is important to note also, that the "obligation to honor public limit orders" is a valuable franchise in and of itself. The Commission's *Institutional Investor Study* found for example that brokerage income[38] exceeded trading income for every category of specialist measured (categorized by inventory).[39]

The *Special Study* summed up these points as follows:

> "It must be remembered that the specialist is not purely dependent upon his trading acumen for his income. Not only does the book serve on occasion as an outlet for excess inventory, but the brokerage function serves as a relatively riskless source of income. . . . If the conflict of interest between the two functions is to be tolerated the duty to the customer must include the obligation to maintain markets which are fair and reasonable. . . . Since access to the floor confers substantial trading advantages, even without the special knowledge available to the specialist, the privileges enjoyed by the specialist are compatable with the statutory scheme only if his duties to the public are not terminable at will but continue reasonable through good markets and bad, through profitable and unprofitable periods."[40]

To the extent that regulation of the primary market specialist has been imposed in response to demonstrated need, or as a *quid pro quo* to certain privileges, and to the extent that need or those privileges do not exist in the third market, we believe that it would be unwise and unfitting to impose such regulation on the third market merely by invoking the abstract principle of uniform regulation. Rather it is important to identify the distinctive contribution that each class of market maker can make to the efficiency and liquidity of American capital markets and devise regulation which maximizes those contributions.

The *Senate Report* cited an example of this process in discussing NYSE Rule 113. The Report discussed the differing functions of specialists, third market makers and block positioners and stated:

> "[T]he SEC's job is to determine whether the distinctive responsibility of the specialist in handling public orders left on the book will be seriously compromised if he is permitted to deal directly with institutions. This does

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[34] *Id.* at 142–146.

[35] A significant portion of the testimony taken in the Pecora investigation of 1934 concentrated on the activities of specialists in pools and other manipulative activities that had characterized the bull market of the 1920's. *Id.* at 65. Section 11 of the Securities Exchange Act was adopted by Congress to give the Commission broad authority to regulate the activities of specialists particularly in light of their unique trading advantages and the acute conflict of interest inherent in commingling the functions of broker and dealer. *Id.* at 66.

[36] *See generally*, 4 Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs. 92d Cong., 2d Sess. 7–21, 66 (1972).

[37] 2 *Special Study, supra* n. 3, at 166.

[38] Defined to include only limit order brokerage income.

[39] 4 Securities and Exchange Commission. *Report of Institutional Investor Study*, H. Doc. No. 92–64, 92d Cong., 1st Sess. 1916, Table XII–21 (1971). This source of income is presently the subject, among other things, of a public hearing on intra-member commission rate schedules. *See*, Securities Exchange Act Release No. 10751 (Apr. 23, 1974).

[40] 2 *Special Study, supra* n. 2, at 127–128.

not mean, however, that institutions should be barred from dealing directly with other market makers even if it is concluded that they should not have direct access to the specialist." [41]

With the foregoing as a general framework, a discussion of each category of rules you cited may be helpful.

(a) *Anti-manipulative Rules.* Many of the anti-manipulative rules of the exchanges were adopted in 1935 in response to a request by the Commission after it had made a comprehensive study of trading practices on the exchanges.[42] These rules, sometimes called the 16 trading rules, covered such subjects as floor trading, participation by members in pools and joint accounts, the handling of discretionary orders on the floors of exchanges, use of options, regulation of the conflict of the dual function of broker and dealer and specialist regulation.[43] Other rules have been adopted to restate the anti-manipulative provisions of the Securities Exchange Act [44] and still others to prevent members from engaging in activity which could lead to a violation of the anti-manipulative provisions of the Securities Exchange Act.[45]

The Commission has received no evidence of trading activities in the third market which present the regulatory abuses to which these rules were addressed. Indeed, it may be that, to the extent a particular exchange rule is addressed to activity other than that prohibited by the Securities Exchange Act and the rules thereunder, the exchanges may want to reconsider the necessity for such regulation. The exchanges have already requested the Commission to reconsider, for example, rules prohibiting exchange specialists from trading in and writing options on securities in which they specialize.[46]

(b) *Obligation to Honor Public Limit Orders.* In your comments you stated that not only are third market makers not obliged to honor public limit orders, but also if a third market maker accepts a limit order he is not obligated to execute the customers order ahead of orders for his own account. As pointed out above,[47] this "obligation" to honor limit orders is a valuable privilege providing the specialist with a significant proportion of his income. It can hardly be cited in support of the argument that third market makers have an undue competitive advantage over the specialist. Moreover, if a third market maker does accept a public limit order, he *is* obligated to treat that order fairly and to refrain from competing with the order or suffer potential civil liability.[48] In any event, it may well be as we move toward a central market system that a public preference rule of some type to maintain auction principles would be advisable.[49] As you will recall, the rules suggested by the Commission in its *Policy Statement* is even broader than the exchange rules [50] and the principle established in *Opper* v. *Hancock*, which prevent a broker from competing with orders he holds, in that, if adopted, no member of the system would be permitted to compete at the same price level with a public order, whether the order is an order of his, or another member's, customer.

(c) *Trading Obligations.* Your final example was that third market makers do not have an obligation to trade in manner consistent with the maintenance of an orderly market and that they can enter or leave the market at will.

The Commission believes that the privileges of making markets in listed securities and the privilege of access to the planned composite quotation system carry with it an obligation to contribute to the orderliness and depth of those markets,

> "unless and until it can be demonstrated that the forces of competition can provide a sufficient incentive to the maintenance of orderly, liquid markets under most conditions." [51]

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[41] *Senate Report, supra* n. 7, at 118.

[42] *See* Securities and Exchange Commission, 1 Annual Report 13–14 (1935).

[43] *Id.* at 40–44.

[44] Compare, for example, NYSE Rule 435(3) with Securities Exchange Act Section 9(a)(2); NYSE Rule 78 with Securities Exchange Act Section 9(a)(1).

[45] NYSE Rule 435(5) prohibits circulation of rumors which could in some circumstances lead to a violation of Securities Exchange Act Rule 10b–5. NYSE Rule 410(b) is designed to curb joint activity which if done with a manipulative purpose would violate Section 9(a)(2).

[46] Securities Exchange Act Release No. 10312 (Aug. 1, 1973).

[47] P. 15–16, *supra.*

[48] *Opper* v. *Hancock*, 240 F. Supp. 668 (S.D.N.Y. 1966), *aff'd per curiam*, 367 F. 2d 157 (2d Cir. 1966).

[49] *See Policy Statement, supra* n. 1, at 22.

[50] *See, e.g.*, NYSE Rule 92.

[51] *Policy Statement, supra* n. 1, at 33.

To this end, the Commission has stated that it intends to rescind the exemption from Section 11b–1 now enjoyed by regional exchanges and will propose a rule requiring the NASD to file a plan for the regulation of third market makers in a manner as nearly comparable to the regulation of specialists as circumstances would dictate.[52] In contrast to your apparent conclusion that such regulation should be imposed now, the Commission believes that regulatory responsibilities over third market makers should not be imposed prior to the implementation of a composite quotation system and an opportunity to examine the efficacy of that system. In this respect, the Commission has stated:

> "Plans in respect of regional specialists and third market makers would not have to be filed prior to the system's introduction, . . . since, as the Central Market System Report has recommended, it would be unwise to attempt to design a regulatory framework for market makers prior to observing the pattern of trading which emerges after the system's implementation. These market centers will doubtless have a better notion of their regulatory needs, as will the Commission, after having had an opportunity to observe actual trading practices." [53]

It is our view that third market makers should be subjected to the types of regulation you mentioned not now, but as they are integrated into the central market system and begin to share in the benefits that system will provide.

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We hope the foregoing has been responsive to your request and we will endeavor to keep the Subcommittee fully apprised of additional developments in this regard as they occur.

Sincerely,

JOHN R. EVANS, *Commissioner.*

MERRILL LYNCH, PIERCE, FENNER & SMITH INC.,
New York, N.Y., May 6, 1974.

Hon. HARRISON WILLIAMS,
Senate Banking Committee,
Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR WILLIAMS: At your suggestion, we wish to submit for the record of your March 27–28 hearings on S. 2136 the following materials:

1. Merrill Lynch's statement in connection with reports of our prospective departure from the New York Stock Exchange;
2. Correspondence between Senator Hart and me on the same subject.

Sincerely,

DONALD T. REGAN.

APRIL 11, 1974.

Hon. PHILIP A. HART,
U.S. Senate,
Washington, D.C.

DEAR SENATOR HART: There follow the answers to the questions you sent to me on March 29:

1. Your quotation from my deposition on the Thill case, which has also been quoted by Donald Weeden of Weeden & Co. in recent hearings, is correct.

Immediately following those remarks, I added that at the New York Stock Exchange meeting of January 24, 1973, which I attended, the directors stated their belief that legislation was necessary to require listed securities to be traded on registered exchanges under substantially identical rules.

2a. Yes.

b. The request came to Merrill Lynch while I was on vacation. In my absence the request was sent to Walter Guzzardi Jr., a vice president of Merrill Lynch. He recommended to George Shinn, president of Merrill Lynch,

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[52] *Id* at 33–34. The Commission further stated:

> "The plans submitted would not have to be identical to those now in effect on the New York and American Stock Exchanges (NYSE and Amex) but could be tailored to suit the individual requirements for the respective market centers adopting them."

Id. at 34.

[53] *Id.*

that Merrill Lynch decline to sign. Mr. Shinn approved that recommendation. Their decision, with which I fully agree, was taken not because of our disagreement with the substantive argument as we understood it in its draft form, but because the suggested tactics seemed unlikely to win any wide support.

3. & 4. Since my Thill testimony, I have had many discussions with Mr. Needham about the possible departure of Merrill Lynch from the New York Stock Exchange. In December of last year, when the issue first came to public attention, I sent out a release over our newswire explaining to our branch office managers precisely what our policy was. Our policy remains the same today. I enclose a copy of that release for your information.

Sincerely,

DONALD T. REGAN,
Chairman of the Board.

[Telegram]

Managers Only:

DECEMBER 18, 1973.

The wire services and some market letters have been carrying stories about "consideration" that Merrill Lynch is said to be giving to "leaving the New York Stock Exchange."

For your information, the firms position is as follows.

At present we execute our orders for listed securities on the floor of the New York Stock Exchange and the American Stock Exchange because they are the places where we get the best prices for our customers. On May 1, 1975, competitive rates for agency transactions will come into effect. Then at some time, probably several years later, a national central market may be in operation.

In the interval between May 1, 1975 and the advent of the central market we need to be sure that we get best execution for our customers. We therefore believe that all listed securities should be traded on a registered exchange until the central market is working. A current draft bill, the "National Securities Market System" (S. 2519), contains no such provision. Should there be no such requirement for trading of listed securities, we would have to consider many options, including whether to leave the New York Stock Exchange in order to protect our customers interest.

We do not in any immediate sense contemplate withdrawal from the NYSE. It continues to be the most used and the best mechanism for trading.

At this moment, we want the NYSE to continue to operate. We shall continue to bring our trades there, and we hope the NYSE will have an important place in the still vaguely defined national market, whose rules and character are as yet unformed.

DONALD T. REGAN AND GEORGE L. SHINN.

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
SUBCOMMITTEE ON ANTITRUST AND MONOPOLY,
Washington, D.C., March 29, 1974.

Mr. DONALD T. REGAN,
Chairman of the Board,
Merrill Lynch, Pierce, Fenner & Smith,
New York, N.Y.

DEAR MR. REGAN: On March 28, I filed a statement (copy enclosed) with the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, in opposition to S. 3126—A Bill to Prohibit the Trading of Listed Securities Otherwise Than on National Securities Exchanges. On Page 8, I quoted from your February 1973 stipulated testimony in the *Thill* case:

> "Fixed commissions are one of the causes of trades leaving the NYSE and going to the third market. . . ." Continuing fixed rates will make it more difficult for member firms to compete with third market makers."

New York Stock Exchange Chairman James J. Needham testified on March 28 before the Subcommittee on Securities that subsequent to your testimony in *Thill*, Merrill Lynch informed him that upon the advent of fully competitive commission rates, Merrill Lynch would leave the NYSE.

To assure my complete understanding, I would appreciate your answering the following questions:

1. Was my characterization of your testimony in *Thill* accurate?

2 a. Was Merrill Lynch asked to sign the so-called "Lewis Ad Hoc Committee" letter of February 1974?

b. If so, when, by whom, and why did Merrill Lynch decline to sign it?

3 a. Subsequent to your testimony in *Thill*, did Merrill Lynch state to Mr. Needham or any other representative of the NYSE that Merrill Lynch would leave the NYSE upon the advent of fully competitive commission rates?

b. If so, when, by whom, and to whom?

c. Was Merrill Lynch asked by Mr. Needham or any other representative of the NYSE whether it would leave the NYSE upon the advent of fully competitive commission rates?

d. If so, when, and what was Merrill Lynch's reply?

e. Was Merrill Lynch asked by Mr. Needham or any other representative of the NYSE to express the opinion that it would leave the NYSE upon the advent of fully competitive commission rates?

f. If so, when, and what was Merrill Lynch's reply?

4 a. Does Merrill Lynch intend to leave the NYSE upon the advent of fully competitive commission rates?

b. If so, when was that decision made and by whom?

c. If so, what were the causative factors of Merrill Lynch's position changing since your testimony in *Thill*?

d. If so, please attach copies of all memoranda, analyses and other documents subsequent to your testimony in *Thill* relating to Merrill Lynch's position on whether to leave the NYSE.

Your cooperation in promptly complying with this request will be appreciated.

Sincerely,

PHILIP A. HART, *Chairman.*

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