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Chapter Author: Seymour Smidt, Donald L. Calvin, Donald E. Weeden

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Impact of Composite Tape on Regional Market Centers

**Panelists: SEYMOUR SMIDT, DONALD L. CALVIN,
DONALD E. WEEDEN, DAVID B. HELLER**

SEYMOUR SMIDT, chairman: Mr. Smidt is professor of managerial economics at Cornell University. He received his A.B. in 1948, his A.M. in economics in 1952, and his Ph.D. in economics in 1954, all from the University of Chicago. He was associate director of the Institutional Investor Study, and was principally responsible for the volume on market structure, and particularly the chapter on market making.

DONALD L. CALVIN: Since October 1966, Mr. Calvin has been a vice president of the New York Stock Exchange, responsible for government relations. In 1957 he joined the Illinois Secretary of State's office; from 1959 to January 1962, he served as the Illinois securities commissioner responsible for administering the Illinois securities law; from 1962 to March 1964 he was with A. C. Allyn & Company, Chicago; and in 1964 he joined the staff of the New York Stock Exchange. He has been actively involved with consolidated tape matters and is a voting member of the NYSE in the Consolidated Tape Association.

DONALD E. WEEDEN: Mr. Weeden is chairman of the board of Weeden and Company, Inc. He received his B.A. from Stanford University in 1951. He serves as director of both National Semiconductor Corporation and Bangert & Company.

DAVID B. HELLER: Currently Mr. Heller is vice president and Midwest Stock Exchange specialist for Ralph W. Davis and Company, Inc. He received an A.B. from Harvard University in 1953 and an M.B.A. in

1962 from the University of Chicago. He served as president of Richard Hick & Heller Company, Chicago, a textile company, from 1953 to 1961. From 1961 to 1970, he was vice president, treasurer, and director and member of the executive committee of A. G. Becker and Company, Inc., Chicago; and from 1970 to 1973 he served as president of Ralph W. Davis and Company, Inc.

SMIDT: It is obvious from this morning's discussion, and perhaps simply from the fact that we all are here at this program, that the securities industry is going through a period of extremely drastic change. Some of us have been saying that for many years, but I think everybody says it now; it is too obvious to ignore. And I think it is also clear that every one of the major institutions in the industry and every major category of participant is wondering seriously about its survival. I testified before the Securities and Exchange Commission yesterday and wondered in that testimony how the regional exchanges and the third markets would fare—how their survival would be affected by the introduction of competitive rates. Simultaneously, my colleague at Cornell [David Ratner] was wondering in the *Wall Street Journal* [November 19, 1974] about the New York Stock Exchange's survivability. Many people seem to think that with competitive rates the small brokerage firms will have tough going. I am worried about the survival of the big ones, because I think their problems of adjusting, at least in the beginning, are much greater than those of smaller firms. It is much harder for a large firm to change its mind in case it does not pick the right strategy first.

Our first panelist this afternoon will be Donald Calvin of the New York Stock Exchange who, I am sure, shares many of these concerns about the central market system and who also, perhaps, will share with us some additional thoughts and concerns.

CALVIN: I was on an SEC panel with Don Weeden on the same subject a month or so ago, for which someone dreamed up a program title which I am going to adopt. The title was, "The Consolidated Tape: the Beginning of the End or the End of the Beginning?" I suppose this discussion requires a modification of that title to "The Consolidated Tape, the Beginning of the End for the Regional Stock Exchanges or the End of the Beginning for the Regional Stock Exchanges."

The consolidated tape had its present origins in the report of Mr. William McChesney Martin which, as you may know, he delivered to the then board of governors of the New York Stock Exchange on August 5, 1971. Mr. Martin had this to say in his report, which was a rather brief one, about the consolidated tape:¹

One area in which the New York Stock Exchange can re-establish leadership is in the development of a single "consolidated exchange" tape which is technologically feasible today. It should be undertaken immediately to provide complete disclosure of material information to all investors. Price and volume for every transaction in any stock listed on the New York Stock Exchange should be reported on this consolidated tape at the time of execution regardless of where the trade took place, whether on the New York Stock Exchange, on a regional exchange, in the third market, in the fourth market, or anywhere else. It is logical that the New York Stock Exchange should initiate plans to create this tape for all stocks listed on the Exchange. It will undoubtedly require Securities and Exchange Commission coordination and regulation to require complete reporting of the appropriate information by each source. There appears to be no reason why this consolidated tape cannot be activated by the middle of next year as a first step toward full disclosure in an integrated Central Market System. This would be an appropriate time to abandon quoting prices in eighths of a dollar and adopt tenths as the unit of price changes.

That is about all he had to say about the consolidated tape, but it was enough to get things moving. It also is interesting to note, for purposes of this discussion and also, I think, from a historical standpoint, the complete set of recommendations Mr. Martin made in his report:²

Recommendations To Be Implemented By The New York Stock Exchange Alone:

1. Reorganization of the New York Stock Exchange.
2. Continuous review and emphasis on the financial soundness of member firms.
3. Additional regulation and improvement of the role of the specialists and the block positioners.
4. Prohibition of institutional membership and prohibition of member firm management of mutual funds.
5. Prohibition of crediting commissions against any fee charged for investment advice.
6. Greater use of modern communication systems.

Recommendations To Be Implemented By The Congress, The Securities and Exchange Commission And The Other Exchanges Either Acting Alone Or In Concert With The New York Stock Exchange:

1. Development of a national exchange system providing a national auction market for each listed security.
2. Consideration of increased requirements for entry into the securities business by broker-dealers.
3. Adoption of appropriate segregation requirements with respect to free-credit balances.
4. Resolution of the differences which result in unequal regulation and the elimination of the third market, preferably through the development of a national exchange system.

5. Additional time to be given to the experiment with negotiated rates before any further change is made.
6. The enactment of legislation granting anti-trust exemption to the exchanges coexistent with Securities and Exchange Commission oversight.
7. A coordinated effort to eliminate [sic] stock certificate.

[And, as noted above]

8. Development of a "consolidated exchange" tape.

As a result of Mr. Martin's recommendations, the then chairman of the New York Stock Exchange, Mr. Ralph DeNunzio, followed Mr. Martin's suggestions and scheduled meetings with other exchanges, commencing in September 1971. If you recall the events of late 1971, the SEC began hearings in October 1971 as a prelude to its report on the future structure of the securities markets.

Initially, discussions by the New York and regional exchanges focused on developing a definition of a central market system. Mr. Martin had suggested this; and, as has been alluded to earlier today, the creation of a central market system also had been suggested in the SEC's Institutional Investor Study Report in March 1971. Initially, these discussions focused on defining a central market system because it was assumed that, until there was a definition, the various exchanges were not in a position to determine whether they would support or assist in the adoption of such a system. These discussions continued throughout the fall of 1971. Essentially, the discussions bogged down on the question of institutional membership. One exchange, the PBW, was concerned about this issue and could not agree with the other exchanges as to the details of membership in a central market system.

The discussions then focused on the consolidated tape. In December of that year an agreement was reached between the various exchanges—the NASD was not a participant in the meetings at that time—as to a type of interim disclosure which might be implemented in a few weeks through use of the existing Amex and NYSE tapes, but not through a "consolidated tape" as one would expect that term to be defined. However, in February 1972, this agreement also disappeared. There was renewed emphasis by the regional exchanges, and at this point joined by the NASD, that there should be a fully consolidated tape, that is to say, a tape that would draw no distinction between the NYSE- or Amex-listed stocks, but rather would display last sale prices of all stocks, wherever listed, in alphabetical order, and without any identification of the market where the trade took place. The New York Stock Exchange, Amex, and others did not agree with this approach, preferring the original agreement which provided for expeditious disclosure on an interim basis, while proceeding to develop a central market system and ultimately a consolidated tape reporting last-sale prices

arising from that system. As a result, there were a series of discussions with the Securities and Exchange Commission, and particularly with its chairman, Mr. William Casey, but no agreements were reached. The commission then named three advisory committees, one dealing with the tape, of which Don Weeden was a member; another dealing with the central market system; and a third dealing with block trading and related matters. The commission also proposed, at that time, adoption of its Rule 17a-14 relating to the consolidated quote system, and Rule 17a-15 relating to the consolidated tape. The emphasis was not on the consolidated quote system at that time, but rather on the consolidated tape and on getting a tape on line. The commission proposed these rules initially, I believe, in March 1972. In May 1972, the New York and American exchanges questioned the commission's statutory authority to adopt the proposed rules, but commented on the rules favorably to the extent that they proposed a plan under which a consolidated tape could be developed. Essentially there were two controversial elements in the proposed plan: (1) The user of the tape would decide what information would be displayed on the tape that he would subscribe to; and (2) all trades would be identified on the tape by the market from which they originated. About this time, the advisory committee on the tape issued its report. It recommended, and the commission subsequently agreed, that all trades from all markets would have to be displayed on the tape, notwithstanding what the user wanted or did not want. The commission subsequently (fall 1975) adopted its Rule 17a-15, which, as you know, required that a plan providing for the dissemination of last-sale information be filed. A plan was worked out among the various exchanges and the NASD and was filed with the SEC in March 1973. At that point, the plan was submitted jointly by the Midwest, Pacific, PBW, American, and New York stock exchanges and the NASD. In June 1973, the SEC commented on that plan and made a number of material comments, sixteen in all, most of which would have made material changes in the plan. The New York Exchange responded to those comments in August 1973, in most cases suggesting responses to the points made by the commission. Ultimately, those areas of controversy were resolved, and the commission declared the plan effective May 17, 1974.

The plan provided, as you probably know, for two tapes, Network A, which is essentially the NYSE tape, and Network B, which is the Amex tape. Network A will display all trades in NYSE-listed stocks on the existing NYSE tape, identifying the market where a trade took place if it was not an NYSE trade. The Amex tape would display trades in Amex-listed stocks wherever traded and trades in regional-only listed stocks which met eligibility standards specified in the plan. The plan provided for a twenty-week test on the NYSE tape, to begin twenty weeks after the plan was approved, May 17, 1973. The test did not take place in the twentieth week,

but was delayed because of problems with a uniform short sale rule the SEC had adopted a few weeks earlier. The test is now live; it began October 18 and is presently operating. The tape displays regional trades in fifteen NYSE stocks, and third-market trades from, I believe, five third-market firms that are reporting through the NASD. The data appearing on the current test tape are being monitored, and statistical and other data are being collected. One of the controversial provisions of the plan provides that the test will be used to measure user reaction to the tape. Also, one of the other reasons for the test was that there is no feasible way, the technicians say, to list the trades appearing on a consolidated tape in precisely the order in which they occur. To deal with this problem there is a two-minute reporting requirement. Thus, all trades should be reported within two minutes of the actual sequence in which they occurred. This assumes that reporting is made promptly by the various markets, as required by the plan. The test is to run for the remaining eighteen weeks of the initial twenty, which means that, according to the original plan, the tape would be fully implemented, barring some problem, after forty weeks, that is, by February 21, 1975. As often happens, it presently appears that the anticipated date may not be met. The Consolidated Tape Association, or the CTA, which administers the plan, is working on a number of problems that have developed recently with collecting regional stock exchange and third-market trade reports. These problems with the vendors of the information may preclude the tape from being fully implemented in February.

The long and short of it is that this is where we are after thirty-nine months and sixteen days from the date of Mr. Martin's report—at a cost of a million and a half dollars. This chronology may give you some insight into the types of problems encountered, once a policy decision is made, in the practical implementation of that policy decision. Everyone thought, back in the fall of 1971, that the matter of physically creating this tape would be very simple and could be done expeditiously. Mr. Martin said that it could be done in a few months. And this [composite tape] is a noncontroversial issue on which there never was serious disagreement at a policy level. It may provide some insight into the problems and time frames that may be met with in developing composite quotations and a central market system where both more serious technical problems and fundamental policy differences may be encountered.

I have one final comment. To come back to my title—"The Consolidated Tape, the Beginning of the End for Regional Stock Exchanges or the End of the Beginning for Regional Stock Exchanges?"—one can make an argument that the consolidated tape may not be in the best interests of the regional exchanges in the long run. Most everyone has argued—and I think it has been generally accepted—that the consolidated tape is a favorable

development for the regional stock exchanges. An argument can also be made, however, that this may not be the case. I think in this area, as in the questions of the competitive rate and composite quotations, the assumption has been and continues to be that these developments will inure to the benefit of the various markets other than the New York Stock Exchange. I think that assumption is open to question. It very well may be that these markets will not really gain any advantage as a result of these developments, but will be put at a disadvantage from the position they presently occupy.

WEEDEN: I agree with Don that there still is a question as to whether the composite tape will on balance be good for the other market centers or bad. In discussing two possible effects of the tape, this fact becomes obvious. What the composite tape means to the third market and to the regionals can be divided into two parts: (1) regulatory or disclosure and (2) advertising or merchandising. In the area of regulation, there are clearly some problems that might arise initially in displaying our transactions and completed executions, in sequence, with those taking place at the same time on the New York Stock Exchange. It will expose our activities, for the first time, to the critical scrutiny and evaluation of the public and the broker. They might find by watching those transactions that, in fact, the other markets are not very competitive. It might not change their pattern of order flow at all. It might expose those terrible trades Mr. Martin always referred to; the ones that happen on the Pacific Exchange, after the close, at a significant price discount from the last trade on the New York Stock Exchange, leaving a great many public orders unexecuted at higher prices in New York. It might expose the terrible markups the third-market traders have been enjoying in the privacy of their upstairs market centers. An indication of those spreads has, for the last two years, been displayed through the monthly earnings statements of Weeden & Company. As far as the regional stock exchanges are concerned, there are some who feel that it will expose to the world the fact that many of their transactions are merely arbitrage transactions. The trade was done at some discount or premium to what the market was in New York, and there was immediately an offsetting trade in the New York market with a profit of an eighth or maybe a quarter of a point. Once those transactions are exposed, they may no longer take place. It will certainly give the specialist, for the first time, some knowledge of what is going on elsewhere. We do know, from our experience over the last two or three weeks, that there is a great deal of business, or a relatively sizable amount of business, taking place on the regionals and the third market. Certainly, in the more active New York stocks, I think the figures in the aggregate show that about 24 percent of the total share volume is occurring in those other market centers. That probably is the most persuasive statistic, whatever the users think, for

continuing with the process of developing a composite tape. Those are the regulatory problems. To the extent that markets or transactions were taken to the regionals or the third market to obtain the privacy of those markets, and absent that privacy will direct their orders back to the New York Stock Exchange, the composite tape might turn out to be disadvantageous to the regionals and the third market.

The other aspect of the composite tape is its function as an advertising or merchandising tool. In going back and analyzing reasons why the marketplace in listed stocks ended up in New York, a key element that emerges, in addition to the existence there of a well-established, well-capitalized specialist system, is the ability of that market to advertise its trades visually, on a real-time basis. Having that ability over a long period of time, the New York market began to attract orders from all over the country. Those orders first came in, as a result of their correspondence, from regional firms that were not members of the New York, but were developing more and more business in New York-listed stocks. Ultimately they found it worthwhile to join the New York Stock Exchange. As that market developed, regional companies that had traditionally been listed only on regional exchanges found that there were some benefits to exposure of their prices, and exposure was available only on the New York Exchange. The result was a great effort by corporate issuers to be listed on that marketplace. All those characteristics had a cumulative effect over many, many years of attracting corporations whose stock was being traded and brokers who originated the orders and of enhancing the ability of capital on the floor to provide good markets. This occurred in a framework of high competition and was, frankly, one of the main reasons that New York developed its premiere position. To the extent that the other markets now have an opportunity to become part of the tape, it also will give them front-shelf space in the supermarket. I think that it also gives an aura of what we might call legitimacy to their trades. There are enough institutional traders here who recognize that there is something about a New York execution that can't really be argued with in the courts. There is a presumption of best execution. There is a public print. Because of that print and the subsequent disclosure of those trades and their range and the other statistics made available later on in the newspapers, people are satisfied if someone executes on the New York. That kind of trade has a "legitimacy" that trades in other markets might not have. I think once we all get on the tape, we might see a change in acceptance of a third-market or a regional trade, particularly for those falling outside the range of trading in a particular market center. You all know that if you send an order into the Pacific Exchange and there has been one price, $42\frac{1}{8}$, and the quote is 42 to $42\frac{1}{4}$ on the New York, if the Pacific specialist bids 42, which is equal to

the New York bid, the broker will not make that trade on the Pacific Exchange. He will send it on to New York because that is where he gets an official print and everybody is satisfied. Of course, we all know that there are split orders that attempt to deal with that particular problem. There are persons and systems, such as Comex on the Pacific Exchange, that do it on or better than the last or the next execution in New York. I think when we all have our trades up there, and people get used to the fact that those trades generally are equal to one another, there will be a tendency for both brokers and the public to accept the trade at 42 on the Pacific Exchange, just as they would accept it on the New York Exchange. Therefore, it will improve the order flow to regional market centers. It will break the New York specialist's ability to control the market. It will tend to attract more capital, stronger capital, that might be more willing to be continuously competitive to the regional exchanges than you have at present. Just as you have relative levels of aggressiveness on the New York Exchange, you have the same range of capability on the various regional exchanges. I think, generally, a tape will open up and encourage more capital to come and assume specialist or market-making responsibilities. It also will open up to the regionals the ability to have a real book, a book that provides them with opportunities to earn floor brokerage on limit orders.

As I said before, the survival of the regional exchanges and the third market is going to depend on their ability under this more open, competitive atmosphere to develop and to offer a competitive package of communications, access, and market making.

HELLER: Let me begin by noting that I am a member of the SEC's Central Market Advisory Committee. Whether or not the committee will have an impact on policy remains to be seen. In my view, the composite tape functions; at least it functions in the fifteen stocks chosen for its trial period. I am able to observe it; I am able to tell where a trade has taken place. I assume that if it functions with fifteen stocks and if Mr. Calvin and Mr. Weeden can iron out their differences, it can function with eighteen hundred. From my vantage point it has had a zero impact. It is not meaningful. I think the regulatory problems, the arguments on the short sale rule, can be ironed out. I think the disclosure is positive. I think people are entitled to see what is taking place. There is one problem that has to be addressed; the print on the composite tape shows the trade and the marketplace in which it is done but does not show who does it. If I, as a regional specialist, sell 5,000 shares of American Telephone in New York to a buyer whom I meet in New York, it shows as a New York Stock Exchange trade. I am not sure that this is a plus or a minus, but I call it to your attention.

I think the real issue is, Are the regional stock exchanges going to survive? I will address myself to this more than to the tape. I think their

survival depends on a single factor, the rules and regulations under which the central market system will operate. I think there are basic, critical problems that have to be resolved. For example, does the broker have an affirmative obligation, which will be enforced by a regulatory body, to execute in the best marketplace? That is questionable because of the economics involved. I think this panel discussion is interesting, but hope that we do not forget about the executing broker's economics. If a brokerage firm can buy something at $42\frac{1}{4}$ in New York and have an expense structure of \$10, but can buy it on a regional stock exchange at $42\frac{3}{8}$ and have an expense structure of \$30, this presents a problem to the executing broker. I think there is an affirmative obligation to accept the better offer, but we also have to recognize that a problem remains, which has to be looked at in total by the industry. I hope that with common clearing, with the hardware and a system that will operate effectively and efficiently, these economic disadvantages can be eliminated. There is some question as to who will pay for the system. If the composite tape costs a million and a half dollars, I am curious as to what a composite quotation system might cost. I think you have to look at the economics of execution.

I think the composite tape is a forerunner of the central market system. I think some of the questions you might want to ask yourself about a central market system are: What are the characteristics that such a system may or may not have? Will it be a dealer market? Will it be an auction market? Will it be a combination of dealer and auction markets? These are knotty problems. You can see I am taking a somewhat neutral position on it because I think that classically the New York Stock Exchange has been looked at as an auction market. I think it has provided viability in the system. I think that Weeden & Company has been looked at traditionally as a dealer market; it also has proved a viable part of the system. How do you integrate, if you care to do so, two viable parts of a market system? I hope the regulatory bodies will get some advice from the Central Market Advisory Committee, but they may act on their own, obviously, since we are only advisory.

I think there is one primary objective that is served by a composite tape and a composite quotation system, and it is something that we in the industry rarely verbalize. It is to help us obtain what is best for our customer. I think it is uninteresting to speculate on whether a system will be advantageous or disadvantageous to any member of the system. I believe that the viability of the industry is enhanced if we design something that helps achieve the objectives and the needs of our customers. The issues are complicated, but I think if the question is asked, "What is best for the customer?" and the system is designed to accomplish that end, the industry will remain viable and some of those knotty problems will be resolved.

NOTES

1. William McChesney Martin, Jr., *The Securities Markets: A Report with Recommendations* (Board of Governors of the New York Stock Exchange, August 5, 1971), pp. 23-24.
2. *Ibid.*, pp. 25-26.

OPEN DISCUSSION

Other participants, in order of initial comment:

- Donald M. Feuerstein
Salomon Brothers
- David L. Ratner
Cornell University, Law
- Robert M. Newman
Weiss, Peck & Greer
- Thomas J. Lewis
Josephthal and Company, Inc.
- John A. McQuown
Independent financial consultant
- Donald E. Farrar
University of California, Los Angeles
- Charles E. Rickershauser Jr.
Munger, Tolles, Hills & Rickershauser
- William D. Ireland
Bank of America
- Hans R. Stoll
University of Pennsylvania
- Harvey A. Rowen
*House Subcommittee on Commerce and Finance,
Committee on Interstate and Foreign Commerce*
- Morris Mendelson
University of Pennsylvania
- John A. Jenkins
B.N.A. Publications

FEUERSTEIN: To follow Don Weeden's methodology, I would like to begin by making a comment on his presentation, then ask a question. The comment has to do with his figure that the third market and regional volume has been representing 24 percent of the total. I think it should be pointed out that there is a difference in the way third-market and stock exchange volumes are computed. If Salomon Brothers processes 100,000

shares of stock on the New York Stock Exchange, that is reported once as 100,000 shares. If Weeden & Company has a buyer and seller of 100,000 shares, that is reported twice on the composite tape, as a purchase of 100,000 shares by Weeden and then as a sale of 100,000 shares by Weeden. Now this may sound like a flap by Don Weeden to inflate his volume. Interestingly enough, this all comes about because of the insistence of the New York Stock Exchange that Don Weeden report his trades in this manner. What happened was that the NASD, which was not in favor of this method of reporting, knuckled under to the New York Stock Exchange so that the composite tape would not be delayed. So I think if you were going to pool our exchange volume and third-market volume on a comparable basis, the comparative figure would be somewhat smaller than 24 percent.

RATNER: Isn't the same thing true on a purchase and sale by the New York specialist?

FEUERSTEIN: No, because the whole purpose of the auction mechanism is to prevent a specialist from having riskless principal trades. The purpose of the auction mechanism is to allow buyers and sellers to meet directly so that there are, or at least should be, very rare occasions where a New York specialist has both a purchaser and seller lined up in advance. It is true, when the specialist buys a hundred shares it is printed, and when he sells a hundred shares it is printed, but theoretically those two transactions should not be lined up in advance.

NEWMAN: I would like to add to that, as a specialist on the floor of the New York Stock Exchange. It is my view that as a specialist firm functioning in an auction market it is not part of our job to line up a buyer and seller ahead of time. We buy from the seller and sell to the buyer only when an equivalent public bid or offer cannot be obtained in the marketplace. When public investors are available on both sides of a potential trade, we view our function as being to make sure the potential buyer and seller meet, but we do not participate as a dealer in the transaction.

WEEDEN: I think I heard in that a question from Don. I guess the question was, Are your statements accurate? Everything he said is true. In the development of the tape, the third market had wanted, whenever we had what we called a riskless principal transaction, to report it as a single trade. Quite properly, the New York Stock Exchange said there is an inconsistency in riskless principal trading. The resolution of the problem was, if we have a riskless principal transaction, we would have to report both sides of it. I think what is happening is that we are not having riskless principal transactions. What we do is transform them into an agency trade, in the same way the block positioner does, where we confirm plus and minus an eighth, five cents, or whatever is negotiated; then we print it as a single trade. I think that our experience has been that even though the

possibility is there to create double volume, in fact, we are not doing so at the present time. Correcting my figures of 25 percent. I would say the third-market and regional trade is 25 percent of the total volume, but the additional volume equals 33 percent of the volume that you would be seeing if you did not have a composite tape.

FEUERSTEIN: The question I was getting to is whether, from the tape and the legitimacy it gives to your trades and the other things you talked about, you have been able to discern any changes at all in the third-market share of the volume in those fifteen stocks since the test started?

WEEDEN: I do not think it has changed. I think the only change, according to our traders, is that it has narrowed our profit margins.

LEWIS: Did it ever come up for discussion or is it now under discussion, whether or not on the composite tape you can differentiate between an agency and a principal trade?

WEEDEN: That question first came up in a disclosure committee that reported to the SEC. We decided to do it exactly the same way it is done in New York, where there is no differentiation between agency and principal trades.

LEWIS: It would bring up, apropos of one of the observations from the floor, the question of what is the true volume? Say a trade takes place on the New York Stock Exchange, a 100,000 share trade, part of which is principal. The position house takes its long position and puts it right back on the floor. I wonder if this is misleading to the public as to what is truly taking place in the stock? What is the real volume, the true transaction?

WEEDEN: We know that there are a great many principal trades taking place on the New York Stock Exchange. The specialist transaction or the floor trader's transaction, where he is acting as principal, certainly is that, even though there might be a commission charged on one side. Also the block positioner's transaction, where he is acting as agent on both sides, but is taking part of it for his own account. The question did come up, is there any public purpose to be served by going beyond what the tape has traditionally been showing over the last hundred years in differentiating between public trades and those done when a dealer is involved? That is what you are really saying, Tom. Should we show stock that really does not stay in the marketplace, but just goes through the market, versus stock that stays in or creates a short position? That same question came up. Should we indicate short transactions, short sales? Everyone agreed to expand the tape to include those trades in other markets and report them in the same way that they have been reported. Then, when we all resolve that problem, we can go on to some that are far more complex.

MCQUOWN: I have two questions, one for Don Calvin and one for Don Weeden. My question to Don Calvin is (I want to verify this last discussion), Can you tell me, roughly, what percent of the trades on the

New York Stock Exchange that are printed are principal trades and what percent are agency trades? My question to Don Weeden is, if the New York Stock Exchange specialist were eliminated and the profit that he enjoys came out of the system, what would happen to your monthly reported earnings?

CALVIN: This gets down to a difficult matter of definition, and it is controverted. By the way we measure agency trades on the New York Stock Exchange, our data would show that about two-thirds of all the trades are agency-type trades, that is, auction market trades, where public orders are on both sides of the trade.

MCQUOWN: Does that apply, though, to the specialist who is not a party to the trade?

CALVIN: The specialist would only be a party to those trades when he acts as a broker in executing the order from his book. That is the controverted part. He is, in fact, when he executes an order from the book, acting as agent, not as principal, and those trades account for about 59 to 62 percent of the trades. Now, the balance of the trades would involve a dealer, a professional for his own account, either on one or both sides.

FARRAR: Do you distinguish number of trades from dollar volume or share volume?

CALVIN: We have, and you will see this data, as it will be included in the testimony we will present to the SEC next month at the commission's 19b-3 hearings. We do have it broken down by transaction and dollar volume. I am not that good at numbers to accurately recite it to you, but you will see. I was talking about transactions. The dollar-volume amounts? The percentages obviously are different, but the relationship is obviously the same. It is pretty much the same.

WEEDEN: If you are saying our volume is overstated, I will have to keep that in mind when we negotiate who is going to pay the cost.

CALVIN: I am not talking about your volume at all. Mr. McQuown's question was about NYSE volume. In terms of your volume, I am glad you brought that up, because I did want to talk about it. On the test tape for the first ten days, from October 18 to November 1, it is interesting that the third-market volume in those fifteen stocks accounted for 6.2 percent in terms of shares, and 4.4 percent in terms of transactions. Share volume probably is not a fair measure; a measure of transactions would probably be more accurate. I would assume, from what Don said earlier, that only a part of those percentages in fact represent dealer trades because you were saying you are doing those stocks as agency trades, rather than as riskless principal trading.

WEEDEN: My own experience is that the volume you are seeing there is primarily dealer business.

CALVIN: It is interesting just by way of information, and probably nothing more than that, to observe that in terms of transactions during these eleven days, the Midwest Stock Exchange accounted for 7.9 percent; the third market, the over-the-counter market, 4.4 percent; the Pacific Exchange, 5.5 percent; and the PBW, 3.6 percent. That is the way it breaks down.

WEEDEN: Mac had one other question, on separating our commission revenue from our dealer revenue. All I can say is that we had hoped the Wells Fargo group, along with the University of Chicago, would come in and design a program that would have allowed us to break that down into two separate groups. I would have to say that most of our profit is derived from dealer spreads, although the other variable, in these very volatile markets, is the market appreciation or depreciation that you get on your inventories. I would say that in these markets probably most of your profit, or lack of profit, comes not from spread or from brokerage but from having made a good or bad decision on whether to take on a dealer commitment.

McQUOWN: Don, the thing I am interested in is, if the New York specialist's spread were zero, would that imply that the competitors' market spread also would have to be zero?

WEEDEN: That is a theoretical question that I would have great difficulty answering because, thank God, it is not zero. To the extent that they were working for nothing in a competitive marketplace, we would have to do so too in order to remain competitive. If we could get up to the point of working for nothing, we would be way ahead of what our last two years' experience has been.

RICKERSHAUSER: The last point made me want to say something specific. One of the competitive aspects the Pacific has provided is that it does cashing and accounting for its specialists at a flat monthly rate. A Pacific specialist could in fact have a zero spread at a particular time and not actually lose money in terms of his back-office charges. Most others have a cost with each trade, specifically assigned to that trade, so they actually lose money on a zero spread. That is just one example of some of the kinds of things that happen when you have a group of minds working on these problems.

The question I want to ask is. . . We happen to have the luxury of having a number of people here who are in the "real world," and I distinguish them from those in the legal profession or those who work for the government or for universities, whom I define as being not in the real world. I am interested in knowing whether anyone who is in the real world of trading has formed an opinion, after twelve, fourteen, or eighteen days of operation, about what a composite tape is likely to do to the smaller marketplaces? I just wondered if anybody in the business has an

impression as to which set of arguments, those against or those for the common tapes, would prevail.

IRELAND: The first two or three days after the tape started, I madly hit the button every time I saw a third-market trade to see whether Don was a buyer or seller by the way his prices differed from those on the last sales in New York. That has gotten rather tiresome. Right now, I really do not pay that much attention to it.

RICKERSHAUSER: Does it have any impact on your feeling regarding the legitimacy of the trade? Does it have any impact on your desire to order your broker to do business in a particular market center because now it is printed in full public view?

IRELAND: I have no response to that. I have not done anything more or less than I did before the composite tape began its trial phase.

STOLL: In the academic world we have a theoretical construct called the random walk, which says that past prices do not matter. That what you are concerned about is the next price. In that kind of world, a transactions-reporting tape would be of very little importance. What is important would be the composite quotation system, because that tells you the prices you will be able to get or could have gotten, depending upon how good those quotes are. It would be the only effective advertising mechanism.

WEEDEN: I think there have been a couple of times when we have been very active in a stock, I think First National City Bank. We feel we have gotten calls, having put on some larger blocks of stock, from people that we would not have gotten calls from had it not been advertised on the tape. From our experiences with those people, I think, frankly, we are surprised that we are not getting more calls because of what we are advertising on the tape.

STOLL: That means, I assume, that the tape serves as a surrogate for the quotation system. It means, "We make markets. We do not have a composite quotation system, but if there is some way to tell people we have done it in the past, they may presume we will do it now."

WEEDEN: Yes, someone will come in and say, "Was that you who printed the City Corps, and what is your ax to grind now because I have an interest."

CALVIN: But isn't it true that your quotes are on NASDAQ or AutEx, so your quotes are being advertised to that extent?

WEEDEN: Our offerings and size are on AutEx. NASDAQ's only purpose was to expose to the member firms their responsibility to go to the best market. To the extent we had better quotes than New York, which they were getting supposedly in the same area, they would feel some sense of responsibility to come and find out how big our bid or offering was. Unfortunately, the member firm community has managed to ignore that responsibility with great consistency.

CALVIN: The answer to my question is yes, for the record. I think when you get into discussion of the composite quote I would offer the same comment I offered at the close of my remarks regarding the composite tape. I think it is questionable and arguable, at least, that this will prove to be an advantage for the regional markets and the third market.

I would like to say one thing here that is related but unrelated; that is, I would like to align myself with remarks by both Dave Heller and Don Weeden that what needs to be focused on here is the economics that exist today when you talk about a central market system or tape or quote system tomorrow. I do not think that the debate over whether there should or should not be a central market system is realistic. I think the real issue is whether this should be an auction market type of system or a dealer market type of system. What exists today is that the third market is really an adjunct to the auction market system that exists on the exchanges. I think if there were assurances to the community—this is the general industry view at least—that there would continue to be an auction market, there would be much greater acceptance of the overall concept. What it gets down to, in the impact on the regional exchanges in these areas, is the economics of the business, that is to say, the willingness of broker-dealers to assume risk. Market makers are market makers only because they are risk takers, and they assume risks only in anticipation of potential profits.

Just to rebut some of the things that were said this morning about lack of competition: anyone who has spent any time on the floor of the New York Stock Exchange and does not think there is competition there is sadly mistaken. There is competition down there continually. Those people risk their capital every day. They are directly affected by it. It is not something that artificial barriers created; they have very strong incentives to compete. Now the regional exchanges and the third market can only improve their position, to the extent that they are willing to assume comparable risk, by making markets in a competitive way—which translates into better markets. To do that, they have a chicken and egg sort of proposition. They argue that they would be willing and able to make better markets if they could attract the flow of orders. Unless they do attract the flow of orders, however, they are not willing to make those markets, because the risk taking required in order to do so is much greater than reasonable men would assume. But you have to remember a point that Dave made when he questioned what regulation would be imposed. He posed that as a question with respect to the future viability of the regionals. I think you have to assume that there is going to be greater regulation of the specialists on the regional exchanges than there is today. If that means that they are going to be less competitive as a result, then they are in trouble. What it gets down to is the incentives they have for taking a risk to attract the flow of business away from New York to their own floor. I do not think that

these devices will do it any more than the so-called arbitrary restrictions that we talked about this morning do it today to make it happen in New York. Rule 394 does not make it happen. It is the competitive markets made there that attract trades to the New York floor.

HELLER: Mr. Calvin and I are in total disagreement; you simply cannot be a market maker unless you have inquiry. If inquiry comes because the broker—I am talking about the retail broker—finds it more economical to do business on the floor of the New York Stock Exchange than the regional stock exchange, he will sacrifice execution for economy. The problem is a chicken and egg problem, which I am hopeful the regulatory authorities will resolve by requiring—as eventually they must require—that where the best bid or offer exists is where the execution will take place. I am a regional specialist, and my cry is that I am absolutely willing to have equal regulation, equal capital requirements; but we are going to have to have equality in terms of our ability to attract inquiry as well. Equality in terms of inquiry is to me just a very simple matter of enforcement. If I make the best bid or have the best offer, then I should be hit at either the bid or the offering. If Don Weeden has the best bid or the best offer, he should be hit. It cannot be that you make the best bid, and you find that your competitor is buying the stock an eighth below your bid; or you find out that economically, as a market maker, you have to go to New York and sell 100,000 or 150,000 shares a day because you do not have the inquiry, because the inquiry is not forced.

I do not accept the argument that regional specialists will be weakened by a composite quotation system. Quite to the contrary, I think I am being presumptuous, but we welcome it as long as it is enforced that the best bid or the best offering must be serviced. At that point, you get true competition between market makers. This includes, obviously, that if Don Weeden's firm, or any other third-market firm, provides the best bid or the best offer, they too will attract the resulting order flows.

ROWEN: Would it be economical for a Chicago broker to go to New York instead of the Midwest Stock Exchange?

HELLER: You see that as the problem, but it is not. One of the reasons that you have 90 to 95 percent of the volume on the Midwest Stock Exchange done by dual members who are New York and Midwest members is because it is more economical to do it that way. Unless you iron out the economics, or require execution at the best bid or offering, you never will get the full benefits of competition between market makers, because regional differences in execution costs are astronomical.

MENDELSON: The chicken and egg problem is that there will be no increased flow of inquiries and orders to the regionals unless the regionals make better markets, and they cannot make better markets unless they get an increased flow. One of the major problems is the economic problem

that David Heller just mentioned. All the wire houses, for example, route their orders automatically. It is just too expensive to send them to a regional exchange rather than to the New York Stock Exchange. The consolidated tape by itself is not going to do a thing about it. There is nothing that has been said, that I can see, that would make the consolidated tape hurt the regionals, but then neither has anything been said, that I can see, that would help the regionals much. Mr. Heller said that you have to have a sort of price priority. There are two things wrong with that. First, a consolidated tape does not tell you where the best market is. It only tells you what the last execution was. We need at least a consolidated quotation system to determine where the best market is on a real-time basis. Second, even with consolidated quotations you will have a very real problem for a very large part of the industry. It is true that a small brokerage firm can examine the CRT (cathode ray tube) display, determine which is the best market, and can pick up the phone and direct his order to any market he wants; but the staff of a major wire house that is handling thousands and thousands of orders daily just cannot stop to consider each particular order, carefully examine the array of prices, and determine which is the best one. They need a more automatic or automated system to handle that kind of order flow. I think the industry is just going to ask for trouble if it expects the individual firm to develop the kind of system that will at all times route orders to the "best" marketplace on a price basis, when NASDAQ can provide such a system for all firms simultaneously at very little extra cost.

WEEDEN: I just want to add to what Dave said about the best bid and best offering. In the real world, sometimes in those volatile markets where we are the best bid or the best offering, we wonder what somebody else knows that we do not know. We wish that we had a chance to reconsider our bid or offering. I disagree with Dave, however, when he says that one of our first priorities should be to try to equate the costs in all marketplaces. I think that the different marketplaces are trying to compete in terms of providing lowest cost. Lowest cost can be thought of as having two parts. One is lowest cost to the public. I think we all are agreed, to the extent we are moving toward a central market system, that wherever the best price is for the customer, that ought to be where the trade is executed. There is also best cost from the standpoint of the broker, however. I think that is where we are all going to be actively competing, trying to improve the cost connected with executing in our market vis-à-vis somebody else's market. Those costs are clearing costs. One of the things that the Midwest has been very successful at, everything else being equal, is maintaining a lower cost of execution for their members, who also are members of New York, than the New York Exchange does. Absent a better market in New York, much of their members' business is done in Chicago on the basis of better

clearing. I think another cost is the cost of floor brokerage. To the extent that we move to a fully negotiated rate structure, I think there is going to be active competition among various market centers in order to reduce as much as possible the floor brokerage cost connected with using that market. I think, in turn, that if the competition is allowed to operate in a free and fully accessible market, with each market center fully accessible to everybody, then you will see those costs come down. That is going to be both in the public's interest and the broker's interest.

FARRAR: I would like to inquire of Don Weeden, Dave Heller, and perhaps others, Bob Newman, for example, about the extent to which a composite tape does, by itself, provide a fairly close surrogate for composite quotations. To what extent can an experienced trader, keeping his eye on the tape, essentially impute the prices that would be distributed by a composite quotation system, if such a system were developed? To what extent does the composite tape, with unfixed rates and perhaps other rule changes to facilitate access by outsiders to exchange markets (and vice versa), provide a fairly close approximation of the central market system that would exist if composite quotations also were in place?

HELLER: Let me reply if I can. I do not think that a composite tape which shows what has transpired in the real world means anything, because what has transpired changes very quickly as another buyer or seller comes into the market, say, or a piece of news breaks. It does not show, at that particular point in time, whether the bid or the offer has expired, which I will assume to be an agency bid or offering. It does not reveal whether Don Weeden's firm has extinguished its buying or selling interest as principal at that price. It does not tell us whether Bob Newman's firm, or my firm, has extinguished its buying or selling at that price. Therefore, as a participant in the composite tape and an observer of it on a six-hour day, I do not feel it has much significance; but a quotation system will!

SMIDT: Dave, I watched you trade for an hour or so, and I could not get you to take your eye off the tape for more than a few seconds at a time. Whether it was a composite tape or not, clearly it contained important information for you.

HELLER: The only reason it is important, and I will take my cheap shot right now, is because on a regional exchange we are not allowed, even being New York members, to know what the bid and ask is in the other marketplace. Therefore, you look at it as a very poor indication of what is taking place elsewhere in the stock.

LEWIS: A real-world nuts and bolts question to any member of the committee as to what response, positive or negative, you have had from the press regarding reporting in the daily papers of the new volume.

WEEDEN: I guess I know as much about that as anybody. I would say, at the present time, the newspapers are indicating that they do not want to

change, even with composite information available. I think it is probably a lack of understanding of what will be required. I think the newspapers' first interest, again, is the broker's interest in cost. I think they feel they will have to use a lot more space in reporting all the composite tape activity: they will have to show it in separate columns, or they will have to separate it out and have information from all marketplaces. They are adamant about not using any more free space in their newspapers. I think, if it is explained that composite information will be more valuable to the public, show more of the volume and the accurate range that took place in all the markets, that it will take no more space than what they had for New York information only, they will come around to recognizing that it is no more trouble and would be of greater public interest. I wanted to answer Don Farrar's question also. I think that once you get a composite tape, there is a good chance that what we had hoped would happen by putting our quotation on NASDAQ but did not, will happen. Say we buy a block of stock at 41 when the last sale in New York was 42, and brokers continue to send buy orders to New York and get executions at 42. We, having bought that block as principal, will begin to show trades at $41\frac{1}{4}$ or $41\frac{1}{2}$. I think it will not be long before customers of Merrill Lynch, Bache, or whomever are going to say, "Look, we would appreciate it if you would go and explore that market and see if you could have gotten us a better price." I think that slowly but surely the composite tape is going to impose a responsibility on brokers to get best execution in listed stocks that are traded over the counter as well, a responsibility member brokers have up to now adamantly refused to recognize.

CALVIN: May I ask Mr. Weeden a question? Do you feel that your firm has that responsibility [for best execution] today?

WEEDEN: Our firm does not operate as a broker; we operate as a dealer. We have an arm's length relationship. It is our customer, whether it is an institution or whether it is a broker, who determines whether or not the price that we are offering or bidding is the best available. I know that sometimes we say we think we are not competitive. We might have too much of that stock, and we say, "Donny Stone is a good market maker. Why don't you try the floor of the exchange?"

CALVIN: You are drawing a distinction, then, in terms of best execution, that does not apply to a firm that acts as a dealer. Do you assert that there is no responsibility to seek out a better market if you are acting as a dealer in that stock? Is that what you are saying?

WEEDEN: If a customer wants to give us an order and asks us to act as his agent, we will be happy to go anywhere in order to find the best price. We would even go onto the floor of the exchange; but unfortunately, we could not continue our established business if we could not also conduct our market-making activities.

CALVIN: But then you are changing what I think you said earlier. You do feel that you have a best-execution type responsibility, even though you are acting as a dealer?

WEEDEN: No. I said that if they want to give us an order and ask us to act as their agent, we have a best-execution responsibility.

CALVIN: What about when you are acting as a dealer?

WEEDEN: No, in that capacity we make a market. We have no more responsibility than does my good friend Robert [Newman] here to explore other markets before he executes in his own market.

CALVIN: The only reason I raise this is that there are a lot of responsibilities. One possibility that is a continuing concern in this whole area is that present firms, which act principally as agents or as brokers, will under a regime of competitive rates act principally as dealers. If that does happen, and if they lack a responsibility to take an order or shift the order around, as Don is saying they may, then you have a question as to what has been accomplished in terms of finding a better execution for the customer. In other words, it would seem under those circumstances, which I do not know to be a fact, that the responsibility then falls back to the customer, not the dealer, to seek out best execution.

WEEDEN: I am glad you brought that up, Don, because I do think that is a problem. I think when a customer comes in to a broker, intending to ask him to act in his best interests as an agent, and then finds out that he did not in fact act as a broker, but as a dealer on the other side—even though that is somehow revealed to him after the fact by a confirmation that comes in and has in small print down in the corner that he acted in this case as a dealer—then the customer may justifiably wonder whether or not he has obtained “best execution.” I believe that a “broker” has a responsibility, before he acts as a dealer, to explore the other markets to see whether or not his customer can do better there.

CALVIN: That begs the question a bit. In other words, the firms could get around him. If this is the status of the law—and I do not know that it is or will be—and the best-execution responsibility does not carry to a dealer, a firm could avoid that problem by advising the customer, well in advance, that it is acting as a dealer, and advise the customer otherwise when it decides not to do so. That is essentially what you are saying you do. This again poses a basic question before the house regarding what we are talking about when we refer to a central market, a national market system, or whatever. In terms of these responsibilities, are we talking about a system that will become primarily a dealer-oriented system or will it continue to be primarily an auction-oriented system? Now if it is one and not the other, then the whole scenario changes. If it becomes a dealer-oriented system, it then seems reasonably clear that it is going to be very difficult to achieve many of the objectives that people describe as noble objectives, because dealers traditionally, and I think properly so, act

differently than agents. That is basic. How you can tie dealers together is one matter. The basic problem we have had in discussions over the composite tape and over the central market system has been, How do you integrate third-market dealer activity into the existing exchange system? There are basic dissimilarities, and that has always been the tough problem. I remember we went back and met with the SEC on this in December 1971 when we first thought we had an agreement on the composite tape; the commission said, "Fine and good. Now, how are you going to integrate the third market into what you are proposing here?" We said that was a question we would address ourselves to, and I said we would get back to it next month, and we have never really gotten back to it.

JENKINS: There was a discussion earlier suggesting that the tape will not be coming on line as scheduled. I would like to ask Don Weeden if he could give his best estimate as to precisely when, if not in February, this tape will become fully operational?

WEEDEN: As far as I know, February 21.

JENKINS: But you should say in all fairness, though, "at this point in time."

CALVIN: I agree with that. As I understand, "at this point in time," there are problems which may require either a delay in that date or some modification of the original full implementation proposal as envisioned by the plan.

WEEDEN: I think there is always a possibility that something might blow up, people are not able to do the programming or the testing in time; but at this time, despite the increasing closeness of that date and the many things still to be done, the Composite Tape Association is cooperatively making an effort to meet the target date.¹

FEUERSTEIN: We have been discussing the possibility that brokers in whom customers were reposing trust and confidence to find best execution might seek to shirk that responsibility by calling themselves dealers rather than agents. In this regard, I think it might be instructive to note the suggestion that in the formulation of Rule 113, there was a mix-up between the Amex investigation, which basically involved abuses committed by specialists handling "not held orders" for individuals, and the implementation of Rule 113, which precluded specialists from dealing directly with institutions. Perhaps a solution to the problem we are discussing would be to set things right and reverse Rule 113, making it illegal for specialists and other market makers to deal directly with individuals, rather than making it illegal for them to deal directly with institutions.

NOTE

1. In fact, the February 21 target date was not met. The composite tape began full operation June 16, 1975.—Ed.