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Impact of Composite Quotations on Regional Market Centers

Panelists: WILLIAM H. PAINTER, DONALD M. FEUERSTEIN, ROBERT M. NEWMAN, BARRY E. TAGUE

WILLIAM H. PAINTER, chairman: Mr. Painter is a professor of law at the University of Illinois. He graduated from Princeton University in 1950 and did one year of postgraduate work there before going on to law school at Harvard. He received his law degree in 1954. For four years he was associated with the New York law firm of Devebois, Plimpton, and McLean, and, in 1958, he began his teaching career at the University of Illinois. From June 1971 to fall 1972, Mr. Painter served as special counsel and director of the U.S. House of Representatives Study of the Securities Industry, conducted by the Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce.

DONALD M. FEUERSTEIN: Mr. Feuerstein is a general partner and counsel of Salomon Brothers. He spent four years, from 1966 to 1970, with the Securities and Exchange Commission as assistant general counsel and later as chief counsel–markets of the Institutional Investor Study. He is a member of the Foreign Committee and Third Market Disclosure Committee of the NASD, the Committee on Securities Regulation of the Association of the Bar of the City of New York, the Advisory Council of the University of Pennsylvania Center for the Study of Financial Institutions, the Executive Committee of the University of California Securities Regulation Institute, and the Committee on Federal Regulation of Securities of the American Bar Association. He graduated from Yale University with a B.A., and holds a J.D. from Harvard Law School.

ROBERT M. NEWMAN: Mr. Newman is a partner in the firm of

Weiss, Peck & Greer. Before joining that firm, he was a trader in listed and unlisted bank stocks with Salomon Brothers.

BARRY E. TAGUE: Mr. Tague is executive vice president and vice chairman of Raymond, James & Associates, Inc., Philadelphia. In 1974 he was elected chairman of the board of governors of the PBW Stock Exchange, Inc., the youngest person ever to hold that position. He has been a participant on the Securities Industry Task Force and related committees looking into the development of a central market system.

PAINTER: The topic of our panel today is the composite quotation system. The composite tape obviously is historical in its approach. In other words, the tape tells you what has taken place. It reports transactions which have already transpired. The composite quotation system, on the other hand, if fully implemented, would give people who have access to the central market system an ability to determine the most favorable bid and asked quotes in any component part of the system, whether the New York Stock Exchange, the Midwest or Pacific stock exchanges, the PBW, or the third market, if integrated into the system.

Just by way of background, I think it might be helpful to sketch out where we are. As you know, in May the Senate passed S. 2519, the National Securities Market System Act of 1974. That bill gives the SEC broad regulatory authority with regard to the establishment of a composite quotation system, and in a great many other areas as well. Included is a clause under which registration with the SEC is required of securities information processors, i.e., people who gather the quotes and make them available to members of the market system. As Harvey Rowen pointed out this morning, a somewhat similar measure, H.R. 5050, has been reported out favorably by the House Committee on Interstate and Foreign Commerce. To my understanding the bill does not, like its Senate counterpart, require the actual registration with the SEC of securities information processors. Nonetheless, it does give the SEC broad rule-making power to remove impediments to, or perfect the mechanism of, a national securities market system and to set up, in effect, a composite quotation information device. Meanwhile, the SEC has, as you know, been moving ahead in this area under its existing authority. On November 21, 1972, it received a report from its advisory committee on a composite quotation system. The report adopted the view that the success of the central market system would be dependent upon quotations from all sources appearing in one central location. Therefore, there should be but *one* composite quotation system, instead of a number of competing systems. In addition, the advisory committee suggested that the proposed system should be used only by responsible market makers, namely, people who stand ready to make a bona fide, continuous, two-sided market in a particular security for a specified minimum period. In addition, a market maker would not be permitted to drop out of the system and return to it at will. To ensure that the system would be adequately regulated, the SEC's advisory committee suggested that it be administered by the same central processor that would oversee the operation of the composite tape. One member of the committee, who I believe is here today, dissented on the ground that to require a single composite quotation system would be to establish a monopoly, and might well subject users to the imposition of restrictions by special interests foreclosing the development of new and competing systems, and unnecessarily concentrate power in the hands of one group. That was in 1972.

More recently, the SEC reissued a revision of its proposed Rule 17a-14 which gives the stock exchanges and the NASD until February 1, 1975, to submit proposals for operating a composite quotation system. In the release accompanying the proposed Rule 17a-14 revision, the commission stated that it appears "appropriate" to effect the centralization of all quotations in listed securities, and that "to a significant degree" a uniformity of approach to the development of a composite quotation system will be necessary. To ensure the comprehensiveness of quotations disseminated pursuant to an effective plan, the revised rule would provide that after a plan has been declared effective and has become operational, no person (including a market maker or specialist) may communicate market makers' or specialists' quotations in listed securities otherwise than in accordance with the provisions of the plan. However, the rule would not impose any minimum market-making obligations on specialists or market makers; neither would it foreclose the possibility of a separate quotation system such as NASDAQ being established by the NASD for over-the-counter securities and, to some extent, NYSE-listed securities; nor would it prevent the establishment by the New York Stock Exchange and other exchanges of a composite quotation system for listed securities. The Securities Industry Automation Corporation (SIAC), a jointly owned data processing subsidiary of the New York and American stock exchanges, and NASDAQ, the NASD's automated quotation system for over-the-counter securities, have each sought to obtain the exclusive right to establish and maintain the composite quotation system.

Two other recent developments have been the New York Stock Exchange's proposal to modify, perhaps liberalize, Rule 394 to simplify and expedite the requirements for New York Stock Exchange members wishing to trade NYSE-listed securities elsewhere than on the floor of the stock exchange. As to composite quotations, the president of the New York Stock Exchange recently indicated that he was considering a "compromise," whereby the New York Stock Exchange would agree to give regional stock exchanges access to price quotations presently available only to members of the New York Stock Exchange if the SEC would agree, in turn, to postpone its May 1, 1975, deadline for the implementation of fully negotiated commission rates. As Mr. Needham described it, the SEC "would let us continue on with fixed rates until the composite quotation system and a national clearing and settlement system were in place." Significantly, he failed to indicate that the New York Stock Exchange would make bid and asked quotations available to market makers of NYSE-listed securities in the over-the-counter market—in other words, in the third market. Indeed, the New York Stock Exchange has, for some period of time, been attempting to persuade the SEC and the Congress to eliminate the third market as a quid pro quo for fully negotiated rates and for the establishment of the proposed national securities market system. In one way or another, the issues of composite quotations and competitively determined rates have become interwoven with one another, as well as with the issue of the viability of the third market and of regional stock exchanges. It is, of course, the impact of the proposed composite quotation system upon the regional stock exchanges which is the subject of today's panel.

FEUERSTEIN: It has been stated that the composite tape is only a record of past history. That problem may also afflict this panel. Many of the things that we should be talking about have already been discussed. There is, in fact, I think general consensus among those who have spoken that in order for the regional stock exchanges to survive in an era of negotiated commission rates, when gimmickry will no longer be possible, they will have to have substantial market-making capabilities. In order for either their existing market makers to develop those capabilities, or for them to attract new market makers who will have those capabilities, the regionals must have an ability effectively to advertise their activities. This means they must have a composite quotation system, since, as I said, the composite tape provides only a record of past history. In addition, many participants in the markets are either unable or unwilling to seek best execution because it is not economical for them to do so, because it is not convenient for them to do so, or because they have other reasons not to do so. Thus, in addition to the composite quotation system, there will have to be some means found to force people to seek the best execution indicated on the system.

That leaves little to talk about with regard to the composite quotation system, except the issue of whether it would be better to have the hundred million dollar composite quotation system suggested by the New York Stock Exchange or the much less expensive modification of NASDAQ. The latter would enable us to go about our other business much more expeditiously. The system suggested by the New York Stock Exchange, which we cannot afford, unfortunately, would take many years to develop, forcing everything else to be delayed in the meantime. Rather than addressing that question, I would like to address a question that I think underlies the entire issue of the composite quotation system and, indeed, the whole concept of competitive market makers.

We have today a specialist system; and the essence of that specialist system, in my opinion, is subsidy, a subsidy of inactive stocks by active stocks. There certainly is no reason why competition would not result in an excellent market in American Telephone common stock. It, in fact, does in American Express common stock. But not all of the stocks listed on the New York Stock Exchange are active stocks. Indeed, perhaps only 20 percent of them are. Therefore, we have a large number of inactive stocks which, at least according to the traditional theory, have to be subsidized, that is, we must have affirmative regulation to *require* a specialist to make a better market in those stocks than he would make in his own economic best interest. In order to have the carrot to induce him to do so, we give him a franchise in the active stock. Therefore, in Bob Newman's case, in order to get the franchise in Fannie Mae common stock he also makes a market in Kirsch, which may be a very fine company, but not a company that has very active investor interest. The question then asked by the theory is whether if Bob Newman no longer has a monopoly franchise in Fannie Mae, he would still be willing to make a better market than would be economically called for in Kirsch? I think this is a question that is necessarily posed by the composite quotation system and by the larger issue of competing market makers. Unless the SEC or some other national agency is going to set up uniform books of stocks throughout the system, so that anybody who makes a market in Fannie Mae also has to make a market in Kirsch, the operation of Gresham's law will then necessarily lead to the refusal of Fannie Mae market makers to make a market in Kirsch. They will say to their own market center, "If you force me to make a market in Kirsch, and I do not have to do it in some other market center, I'll simply move my Fannie Mae activities there."

This leads to some important questions that I think should be addressed. First, why is it that Kirsch has to be subsidized? There are certainly a large number of stocks, presently unlisted, that have trading characteristics not superior to Kirsch, but yet have a number of very active and interested market makers. I suggest to you that the reason Kirsch has to be subsidized is because the auction market mechanism, which is very important and very useful for active stocks, is a luxury that perhaps we cannot afford for inactive stocks. In an inactive stock, a large percentage of the volume must necessarily be that of the dealer. If the dealer has to print all his trades on the tape, he will be disclosing his position to those who may trade against him, and increase the risk to himself of taking that position. Second, the principle of the auction market is supposed to eliminate riskless principal spreads. The auction system is supposed to result in the meeting of public orders directly, whenever they can do so, without the market maker's skimming off a riskless principal spread. That, of course, also is a very good idea, but it necessarily reduces the profitability of the security to a dealer. So we must ask whether the composite quotation system and competitive market making will prevent us from subsidizing the 80 percent, or whatever the number is, of listed stocks that are presently subsidized because they are inactive; whether, if they are delisted, they will have a better market or a worse market.

I think there is another question that has to be addressed. The specialist is not an eleemosynary institution. If he is making a better market than he would like in Kirsch, and therefore not making the return he would like on his capital or perhaps even losing money, he must make up his loss somewhere else. Theoretically, and presumably, he is making it up on his market in Fannie Mae. He is taking more out of that market than competition would allow him to. Therefore, we must then ask: Who has decided that the shareholders of Fannie Mae should subsidize the shareholders of Kirsch? Is this in the national interest? If it is in the national interest, who is administering the subsidy; who has decided how much it should be? I think all these are questions that we have to address and face before we can go forward on the mechanics, the nuts and bolts of a composite quotation system.

NEWMAN: I could spend a lot of time defending the role of the specialist on the floor of the New York Stock Exchange, but that is not our purpose today. It would appear that we are gradually, but steadily, moving toward the reality of a central marketplace. There are many problems that surface, and the issues that surround the problems are many-faceted. To say the least, many are controversial. One of these areas is the composite quotation system. If we have a central market as the final result of deliberations by the SEC, the Congress, the industry, and the Justice Department, then there must be access to that market. A quotation system is necessary to achieve that result.

My views are based solely on practical experience as a member, for approximately eight years, of the professional trading community. There are a number of points in the form of questions that I will ask, because I won't presume to describe to anybody in this room what the results of a composite quotation system will be. Among the topics that should be examined are more equal regulation and open access. By equal regulation, I do not refer just to regulation among market makers; I include the regulation that affects all the parties who have access to the machine. Capital requirements: I know the SEC is working on a uniform capital rule now. Competitive rates: Are they going to be posted or not posted? There are some institutional people who would like rates, even though they are fully competitive, to be posted by the various member firms of the New York Stock Exchange.

The availability of specialists, capital, and market-making talent is a very important subject. There are a great many people in the professional trading community who are concerned about the lack of enough qualified market-making talent in this country to assume the responsibility that new methods call for. Surveillance: Will there be adequate surveillance when you have a composite quotation system? As it now stands, the systems that are being developed do not have real-time capability adequately to survey what is happening now. Similar to the composite tape, these systems report primarily what has happened, not what *is* happening.

The impact on regional exchanges is something that I cannot begin to answer. Will open competitiveness force the regional exchanges out of business, or will advertising of quotes in a competitive quote system do so? I cannot tell you whether quotations will help or hinder the regional stock exchanges or the third market. Only time will answer these questions. The impact of the best execution—i.e., the switching of orders by member firms to where the best quote is displayed—all these are knotty problems. They are problems on which I cannot presume to make judgments as to what will happen. I just want to make everybody aware that these questions exist, that they are serious, and that they should not be disposed of lightly.

TAGUE: We have before us today proposed Rule 17a-14. As I read it, 17a-14 requires the exchanges and associations whose members make markets in securities registered on national securities exchanges to establish a plan to make quotations available on a real-time basis, through authorized quotation vendors, by February 1, 1975. Don Calvin and Bob Newman have raised some very interesting questions and points. I also do not know what the advent of composite quotations will do to the market system. However, I would like to take this opportunity to trace a bit of history with you. I feel it is absolutely essential that we move toward complying, unilaterally, with 17a-14, and propose plans to the Securities and Exchange Commission for implementing a composite quotation system. I think it is essential, and I think a look at history will tell us why.

Some years ago a substantial monopoly developed for the major stock exchanges in this country. The product of this monopoly became excessive commission rates. Since fixed commissions rendered effective competition inconsequential by edict, the only event which mitigated against a total monopoly developing was the commission's multiple trading case decision. No reliable gauge or competitive force otherwise would have existed for judging the fairness of fixed minimum brokerage commission rates by the SEC. Activity in the marketplace was primarily generated by the public customer who individually failed to command much attention. Additionally, the fifties and early sixties were characterized by good markets; generally everybody was making money; the social atmosphere was reserved; people were content and generally happy; and consequently, if the exchange asked for a rate increase, the SEC granted it. A second condition prevalent during those years was an almost total market-making monopoly for specialists on the major stock exchanges, where over 90 percent of the volume in listed securities took place.

Regional stock exchanges proved poor competitors for a number of reasons: (1) Many rules, and even more importantly, implicit pressures were brought to bear upon regional firms by major exchanges, resulting in the regional firms bypassing regional for New York market centers. The main argument centered around a term called "fragmentation." This was a Madison Avenue expression which supposedly referred to a splintered, auction market process, to the detriment of the public. (2) Regional stock exchanges, and regional specialist units particularly, lacked capital, the capacity, and to a great extent, the expertise to compete effectively against the major stock exchanges.

These monopolies, coupled with the exponential increase of institutional activity in the stock market, finally gave rise to competitive alternatives. Some of these resulted in the development of another Madison Avenue catchword—"gimmick." One of the most common gimmicks was something commonly called reciprocity, for in effect, the practice of discounting commissions in manifold ways developed. Why? Because the commission rate structure was excessive, and every broker on Wall Street and elsewhere knew it. This was an example of industry self-regulation at its worst. Today all exchanges have been forced to institute "nonmember access." It is the same thing as reciprocity—only the name has been changed to protect the image. Another so-called gimmick developed when certain "maverick" exchanges allowed institutions—those giants with billions who heretofore had been victims of one of history's most massive rip-offs—to become members and thereby save their pensioners and their policyholders millions yearly, to the detriment of the brokerage industry. I submit to you that had our industry not been so greedy, Mayday (May 1, 1975) probably would not be facing us with its ominous implications today. Public awareness, basic fundamental competitive economics, and time have a very curious way of dealing with malpractice, and that is exactly what our industry was guilty of at one time.

As far as the market-making process is concerned, the rise of viable regional specialists, the third market, and the fourth market became obvious and natural as both nonmember brokers and institutions opted for relief from excessive commissions. This created additional inquiry in other market centers, and with the additional inquiry developed additional market-making interest and expertise. Ergo, the combined auction-dealer market concept administered by a specialist with an exclusive franchise was confronted with an additional ingredient, the rise of viable, effective, competitive market makers in multiple market centers.

About four years ago we arrived at a point where the SEC became firmly convinced that instituting a central market system and, ultimately, fully competitive rates was the only way to resolve the gross inconsistencies which occurred within our industry. In other words, let free competition across the board accomplish what the industry refused to accomplish through self-regulation. Note that I see the central market system as coming *before* fully competitive rates. That I think is key. Perhaps the interest in stock exchange membership which developed among all types of private and public institutions had something to do with it; I cannot say for sure.

Three years ago we finally sat down as an industry, and for the first time in history attempted to identify and resolve issues relative to the creation of a central market system. It was quickly determined that a combined tape, which reported transactions as they occurred in the various market centers, was the easiest thing to implement and, therefore, was the obvious first step. The composite tape was operationally feasible within a matter of weeks, we were told. It simply reported transactions as they occurred, identifying market location. All this was desirable from the standpoint of providing increased exposure and more complete disclosure to the investing public. After developing tape prototypes A, B, C, and D, with their manifold ramifications, a funny thing happened on the way to the first print. A new catch phrase emerged called "equal regulation."

In the months and reams of memorandums which followed, covering a virtual kaleidoscope of rules and regulations, the only thing that was agreed upon was that confusion reigned. Regional exchanges and the third market quickly agreed that the rules on short selling required equalization, but were hard pressed to understand what else. The major exchanges frequently reminded us of our responsibility to maintain the public's trust and confidence. So what happened? After almost four years of finally putting together a combined tape, we are today displaying fifteen stocks. The regulation that was equalized was a short-selling rule, period. With all the technology we were told was required, trade information for the new composite tape has been transmitted initially by the good old-fashioned teletypewriter, and inputs to the tape have been handled manually. That is progress for you. The SIAC people themselves have conceded that we could have accomplished this three months after the initial discussions. Were it not for the fact that the SEC finally banged the gavel, there would be no composite tape today.

That brings me up to the present. Today I am hearing that because of technological problems we are going to have to wait six more months or so before the composite tape is fully operational. Yet I am supposed to discuss the impact of composite quotations on regional market centers. I think it would be more appropriate for my six year old son to discuss the subject some years hence, if experience follows true to form.

I do not mean to be too satirical here today, but I am honestly concerned. I sincerely believe, and here I agree with the major stock exchanges, that the advent of unfixed commissions, if implemented before more of a central market system is in place—i.e., before composite quotations are available—will, in time, probably eliminate the need for a stock exchange system as we have known it. That would be a shame. Despite its inconsistencies, the system is displayed for all the world to view constructive capitalism at its best. In my view, because the central market system has been bound in red tape, the SEC has now reversed its original priorities by putting competitive commissions ahead of a competitive system. This, I believe, exposes smaller regional brokers, as well as regional stock exchanges initially and the major stock exchanges later on, to unnecessary risks.

We read about how multiple dealer markets are being planned and are about to be unveiled. Only the strongest firms can feel assured of their survival in such an atmosphere. We have living proof within our industry today of who benefits most from fully negotiated commissions and who benefits most from a composite tape. It is a big versus small issue. While I distinctly respect the job that Weiss, Peck & Greer, and other very capable New York Stock Exchange specialist firms do, their competition in the future probably will not come from me. It will come from Salomon Brothers; Goldman, Sachs; and Merrill Lynch. It will be concentrated; it will be well financed; and it will be tough. I am sure you have considered that, Bob. Only the strong and the well capitalized are going to survive and remain viable, and perhaps that is the way it should be.

However, I have a responsibility as chairman of the PBW Exchange to help protect the smaller, well-managed broker-dealer, the regional firms who make up the backbone of our membership, and without whom the capitalistic system will be a lot weaker. So, when we talk about the impact of composite quotations, I am worried that with negotiated rates the exchange system might become so weakened that by the time we get around to agreeing on a system, the only remaining participants in it will be the giants. As to the technology, I believe it can be accomplished quickly. Recently I have been impressed with the circumspection shown by the staff of the major exchanges. I left a meeting in New York two weeks ago where, as Bill Painter reported, there was a move on the part of the New York Stock Exchange to change their position. I think they see that their position in opposition to unfixed commissions and in opposition to 17a-14 are inconsistent. I know the pressures to which Jim Needham and Paul Kolton and Don Calvin are exposed. I know how opposed the floors of the major stock exchanges are to the dissemination of their quotes. I know how they feel about regional specialists and the third markets laying off positions in their markets. I know how they feel about the regionals and the third market utilizing their quotations in an effort to be competitive. All I can suggest to them are two things: (1) that the competition between us will eliminate many of these problems that are supposedly posed by unequal regulation; and (2) it is better to have 60 to 70 percent of something rather than 100 percent of nothing. It appears to me that for the first time there is a sense of urgency to negotiate in good faith. I hope the SEC accepts this sincerity, and I hope it forestalls the implementation of unfixed rates. I feel the guts of a central market system can be in place—and that means composite quotations—and in good working order within a year if we approach it diligently.

What is the impact of composite quotations on the regional marketplaces? Simply this. The viable, professional units will receive an exposure they never before realized, and in such an atmosphere they will become even more proficient and more competitive. The other specialists and market makers simply will not make it. Their inability to respond positively in a truly competitive market climate will in time render them obsolete. The choice will be theirs; they will not simply be rendered obsolete by decree. In my opinion, obsolescence appears to be their future destiny. If the SEC's timetable remains unchanged, I feel that it is likely that many more will fall as well—and that would be a shame.

These days everybody is wondering how to get the public back into the market. The elimination of the bear market, of course, is highly recommended. A united, consistent securities industry, which discloses and exposes market information for everyone to see, an industry which prices its products and services fairly and competitively, obviously will help considerably. The evolution of a truly competitive central market system, followed by the unfixing of commissions, is *the* way to proceed. My hope is that this industry will get together now and dedicate itself to that end, because the real danger lies, in my opinion, in putting the cart before the horse.

OPEN DISCUSSION

Other participants, in order of initial comment:

David B. Heller
Ralph W. Davis & Company, Inc.
David L. Ratner
Cornell University, Law

Seymour Smidt
Cornell University
Philip A. Loomis Jr.
U.S. Securities and Exchange Commission
Thomas J. Lewis
Josepthal and Company, Inc.
Charles E. Rickershauser Jr.
Munger, Tolles, Hills & Rickershauser
Donald E. Weeden
Weeden and Company, Inc.
Richard R. West
University of Oregon
John A. McQuown
Independent financial consultant
Donald E. Farrar
University of California, Los Angeles
Morris Mendelson
University of Pennsylvania
William D. Ireland
Bank of America
John A. Hewitt
Chase Manhattan Bank

HELLER: Don, your concept of subsidy interests me. Let me ask you a question. If the Fannie Mae shareholder is subsidizing the Kirsch shareholder because of the market system, since the Fannie Mae shareholder may, at his election, sell the stock and stop the subsidy, is your question valid?

FEUERSTEIN: Certainly, because, first of all, the Fannie Mae shareholder is not assuming that the theory is valid, that he is not getting the full value of his security when he sells. Second, although the Fannie Mae shareholder is free to sell—that argument goes to a lot of things that we do not allow to happen in our system—we must realize that shareholders and corporations still are, to some extent, captives. I think, thirdly, it is a question of where the burden of proof is. It seems to me that we start in our society with a proposition that natural market forces rather than subsidies should determine the allocation of resources. The question really is then, What is the justification for the subsidy? not What is the justification for not having it?

RATNER: I have been impressed by the realistic approaches of the speakers, but disappointed by some of the Madison Avenue phrases, principally in use of the term "central market system." We have had in the past, for some time now, not one but two central market facilities. One is the New York Stock Exchange and the other is NASDAQ. The approach at the moment is that, somehow, these two can be combined; that two totally different approaches to creating a central market can be put together, combining competitive market makers with priority for public orders. I wonder whether this is realistic. Were we misled by the fact that there are now competing market makers in listed stocks? Those competing market makers have, in effect, been subsidized. As Don Feuerstein pointed out, one of the subsidies involves active stocks subsidizing inactive ones; but block positioning by member firms also has been subsidized, by fixed commission rates. The third market, while it has not been subsidized, has been operating within the parameters of a fixed commission rate system. The regional exchanges have been able to operate within those parameters by offering access to people who could not get economic access to New York. Have we been deluding ourselves by thinking that, in a fully competitive era, we could really have a market that combines auction and dealer features? Has such a market ever existed? Is there any reason to believe it will? If not, then we are faced with an important choice which is, if it has to be *either* the New York Stock Exchange *or* a dealer-type market, are there demonstrable advantages to the stock exchange type sufficient to warrant the government's taking affirmative action to preserve it? Do we have any hard evidence as to which type of market—in equivalent stock issues—serves public investors better?

TAGUE: Dave, I think that you have in existence today, on the New York Stock Exchange and, to an obviously smaller extent, on other regional stock exchanges, a combination of the auction and dealer processes. I think some combination of these two processes is the most desirable. I would hate to see the loss of the auction market, and I would hate to see the elimination of the inputs that dealers can make in helping to provide depth and liquidity that would not exist in their absence. I do think that Don makes some very interesting points. I worry about the consequences, if you move in this direction, of it suddenly not being feasible for my firm to have a specialist book in over forty-five stocks. If it does not become infeasible, it certainly becomes difficult to manage, difficult to finance, and there will be a tendency for us to concentrate on only the most significant issues. I do think that some combination of the auction and dealer process is the way this thing should evolve.

FEUERSTEIN: Dave, I do not think we want to get tied up in semantics here, which is one of the problems that frequently arises when we talk about the so-called auction versus dealer market. After all, an auction market is simply one in which there is a mechanism to insure that the best bid and the best offer always are filled. The opposite of that is a negotiated market in which there are private transactions without regard to other bids or offers in the system. A dealer market, if there is any definition for it, is one in which customers have direct access to dealers, as distinguished from an agency market in which public orders must go through brokers. There is some experience as to whether these things are compatible. For example, we do know that with regard to a noncontinuous auction market, a call market, it is perfectly possible to have an auction-dealer market. That is what competitive bidding is for a new utility issue, and that is what happens every time the Treasury auctions off Treasury bills. That is both a dealer market and an auction market. The question is whether you can have a continuous market that also is a dealer market, and I frankly do not see any reason why you cannot.

RATNER: My question really was whether you can have a market with fully competing dealers plus priority for public orders and reporting of all transactions.

SMIDT: I think if you go to the Chicago Board Options Exchange you will see that market. I am not saying it will apply to every stock; yet as a theoretical possibility it is an excellent one.

NEWMAN: As a theoretical possibility, it is definitely possible for that to evolve after a central market has been implemented. All the theory you want to talk about today, however, is not going to take us to that point.

I disagree with my colleague here about the implementation of negotiated rates. My personal belief is that they should be implemented as soon as possible; we should get on with it. Let's find out what will be needed to survive in this marketplace. I recognize that there definitely are some problems in getting to negotiated rates by May 1; but it is inevitable, and the faster it happens the better it will be for all of us. We will learn how to survive. Whether the market that evolves will be a combination of auction and dealer markets I don't know, but let's find out.

FEUERSTEIN: I think there is another point that should be mentioned. Sometimes the rational and idealistic way of proceeding is not the practical way of proceeding. I think we probably all could agree that if you had to sit down and write out the ideal scenario for moving from where we are now to where most people think we should go, the first step would not be competitively determined commission rates. I think you have to examine the question in the context of history. After all, it was only in 1968, six years ago, that the SEC first began seriously to consider unfixed rates. The basic components of the central market system were first considered in the fall of 1970, only four years ago, during the course of the Institutional Investor Study. Unfortunately, we have a situation where, because the securities industry is such a heterogeneous industry, it has been difficult, if not impossible, to reach progressive consensus among the members of the industry without a crisis. Although the ideal way of proceeding might be to implement competitive rates last, the only way to reach our goal may be by way of the old Chinese proverb, "One step backward, two steps forward."

LOOMIS: I would like to give my viewpoint as to what Don has just said. No one even thought of a central market system until they were confronted with the possibility that fixed rates might no longer be present to insulate the old system. We have seen an accelerating rate of progress for the central market system, although we are not there, primarily because people have concluded that they *have* to do it.

LEWIS: Has any discussion come up, or has anything been finalized by the composite quotation committee or other appropriate body as to volume requirements for participants, i.e., as to the size of their market?

PAINTER: This raises the problem from a practical standpoint. It is fine to have composite quotations; but if I look at my composite quotation screen when I come into the office in the morning and see a better price somewhere out in Omaha, do I have a duty to explore that price if I know there is no size behind it—if I know the market maker is not willing to provide any depth at his quotation? For all practical purposes I may end up with a specialist on the floor of the New York Stock Exchange.

TAGUE: These are questions that I think everybody in this industry, and probably every institution that is represented here, would like to have answered. It involves fiduciary responsibility. Where does it exist? When is it required? What obligations does it impose on a broker? I think these questions are in the process of being answered, and some of the legal minds here probably can answer them better than I can. As far as I am concerned, in answer to Tom's question, there is not any composite quotation committee that I know of that has been discussing the depth and size of markets.

RICKERSHAUSER: In trying to answer that question, I think that, first of all, regarding the composite tape, there are meetings going on at the present time. Concerning composite quotations, however, exploratory discussions also began some time ago. Because of the New York Stock Exchange's opposition to any such system and its written position that efforts to force its participation would be unconstitutional, however, it seemed unwise to continue to expend substantial amounts of time and energy on such meetings.

On your question, Bill, about whether or not one would feel obligated to go to Omaha when you know they are good for only a hundred shares, I would like to ask people here what they are doing in the over-the-counter market where that problem presently exists?

LEWIS: I only bring up the question because I have heard at least seven times that there is a deadline of February 1, 1975, for responding to 17a-14. How is it possible that no discussion has been going on as to volume requirements? The date is around the corner.

HELLER: Maybe I can be helpful on this question. I do not believe there is a committee addressing itself specifically to that particular question, but the central market advisory committee has grappled with the problem. What does best execution mean? Does best execution require you to go to Omaha, Nebraska, or Keokuk, Iowa, for 100 shares or 200 shares? All I can say is, I hope there will be some resolution, on an advisory basis, to the SEC. I am not saying, however, that you will see it by February 1.

WEEDEN: We already have the combination of an auction and dealer market on the floor of the New York Stock Exchange. It is imperfect because it does not allow all public orders to come down and be represented with the kind of priority and precedence you want. It is imperfect because it does not have all the dealer element you want. But we do have one combination market, and as I understand, the proposed central market is only an attempt to expand and improve upon that concept. This idea that we are going to something that makes us choose between an auction and a dealer market is rubbish.

To repeat, we already have a central market system, although imperfect. All you institutional traders have the ability to search through the communication systems that have been financed to connect your offices with those of brokers and dealers who are market centers. The institutional or professional business has a central market. The problem is, the *public* does *not* have a central market, and the broker who is representing the *public* does *not* have a central market. I understand that the purpose of our effort to create a central market system is to take something that we already have in imperfect form, some people call it fragmented, and improve it, and provide the benefits derived from those improvements to the public.

Those are the two simple ideas. We already have them in place. All we have to do is use communications and computer technology more efficiently than we have in the past. The problem is that there are big economic interests that are going to be troubled by that change. That is where you have the problem, and that is where the uncertainty is created artificially, in order to create confusion, cloudiness, and therefore postponement. This is in the particular interest of certain elements of our industry, about which I have spoken to you several times before.

PAINTER: Don, can I just clarify one point? Do I assume then, from your statement, that you would be willing to be bound by the SEC's two proposed rules regarding the priority of public orders and precedence?

WEEDEN: I am glad you asked that question, because I think that has to be absolutely clear. No one I know of has objected to the concept of priority to public orders and precedence to limit orders.

PAINTER: So you see that as no obstacle to integrating the third market with the rest of the central market system?

WEEDEN: If we accept the concept of subsidy—if only because there seems to be lack of movement away from it—then why not extend the concept to all stocks, both listed and unlisted? Why do we accept the concept of subsidy only for listed stocks, and why isn't the concept extended of requiring those who receive a monopoly position in active stocks to participate also in the less active listed stock?

A second question is, Wouldn't it be useful for the New York Stock Exchange to experiment with just how necessary it is to provide this subsidy in order to achieve continuous market making in "inactive stocks"? I would suggest a way of experimenting with that proposition in a controlled test. Ask each one of the specialists to toss into the hopper his least interesting and potentially least profitable stock. Within their own membership see whether or not there is someone who would step forward and assume that responsibility without having the Fannie Mae's, but with the privilege of obtaining the brokerage commission from the book. You might even extend the experiment to other groups of stocks, where you expose those stocks to market making by any member firm who wishes to assume the same kind of responsibilities in those stocks that they do in over-the-counter stocks. In many cases, these are even less interesting from the market maker's profit standpoint.

FEUERSTEIN: Don found some questions in one of my statements. I must say that I could not find any addressed to me in his, beyond rhetorical ones. Unfortunately or fortunately, as the case may be, I have spent enough time with economists to come to believe that subsidy, in my vocabulary, is a dirty word.

WEST: I interpreted Mr. Feuerstein's discussion, when he was at the microphone, as suggesting that the argument regarding subsidies is made by advocates of fixed commission rates. But the fact is that no such subsidy exists; so I did not understand that Mr. Feuerstein was supporting the view that this argument was valid. I would like to ask the following question of the people at the conference who wrote the *Institutional Investor Study*. You looked at the behavior of specialists in individual stocks. Did you find that profit rates for making markets in inactive stocks or slow-trading issues were lower than in active stocks?

SMIDT: I will put on my objective hat. We found clear evidence, in high-volume stocks, that there were monopolistic returns. There were higher returns than would be necessary, assuming free entry, for someone to reasonably take on the accompanying risks. Now at the other end, I would say we did not find any evidence that would either support or reject the argument as to subsidies. You can look at the stocks, but to analyze the subsidy argument carefully one would have to compare the quality of the market versus the level of return across stocks in a finer way than we were able to in the study.

I would like now to go beyond the conclusions that could be supported strictly from the data. I think there are some questions about economic logic that are relevant here. Would it be reasonable for a market maker, under the circumstances we found, to subsidize one stock from another? The argument presumably would be, unless you made a better market than was economic in a low-volume stock, you would be penalized in some way by not having better stocks assigned to you. Now, we did not find evidence that those responsible for stock assignment moved stocks from one specialist to another. That would indicate to me that no specialist needed to fear that active stocks would be taken away from him and given to somebody else because he was not doing well enough in his less active stocks. I would have to qualify that. I do not mean to imply that a specialist could get away with grossly inadequate performance. There may be some set of conventions as to what is good enough that we would not have been able to observe in the study. But from the evidence that is available, I am very skeptical as to whether there are subsidies—but I cannot tell for certain.

NEWMAN: The New York Stock Exchange is very much remiss in its allocation and reallocation of securities among bad specialists. However, there is some hope on the floor these days among some of the younger specialists that the new committee that is headed by Mr. Batten [William M. Batten, chairman of J. C. Penney Company and a director of NYSE] will look into the allocation and reallocation process. It is hoped that some of the problems that exist and are complained about vociferously by the legislative and supervisory bodies and the institutional investor group will be dealt with.

McQUOWN: I would like to ask one question. What is the return on investment, risk adjusted, to the specialist?

SMIDT: I have it readily available only for the most active stocks, and only for the period of an obviously better market that we studied. It was done with a certain caution. The figures I will give you are before tax returns on average overnight positions. The marginal costs that one could trace to particular transactions have been subtracted. No attempts have been made to make allocations for fixed overhead, such as the cost of a seat, member dues, or the value of the market maker's time; but the gross, before-tax return on investments for active stocks ranges from about 100 percent to 200 percent per year, in round numbers.

McQUOWN: What is the comparable return to an investor holding the same stocks for a year in his portfolio?

SMIDT: I think there is some data from Merrill Lynch that suggests about 9 or 10 percent per year.

PAINTER: Is that a negative return?

McQUOWN: I would like to ask Don Weeden in which of these two categories, the investor or specialist, do your returns fall?

WEEDEN: I would say, traditionally, we have averaged a 15 percent after-tax return, with the exception of the last two years.

MCQUOWN: After taxes?

WEEDEN: After taxes.

MCQUOWN: Now I would like to go back to Don Feuerstein. Where is the subsidy? I do not understand what you mean by subsidy when specialists are earning those kinds of rates.

FEUERSTEIN: I did not mean to indicate that it is my opinion that the subsidy in fact takes place. I was merely posing the theoretical argument used to rationalize the specialist system.

MCQUOWN: Is it your opinion that it does take place?

FEUERSTEIN: In all too few cases.

HELLER: To be sure we do not mix apples and oranges, Sy, I think the response Don Weeden made was for the after-tax return on investment for a period which I assume to be a year. Am I correct in that, Don? You can look at the statistics on a New York specialist operation, which show the after-tax return, or the pretax return, and they are not 100 to 200 percent. I am being very defensive of New York specialists, saying they just are not that large.

SMIDT: Where do you find the after-tax returns on average overnight positions? I would like to see them.

HELLER: I am not talking about average overnight positions. I am talking about what is taught in business school. If you invest in $100 in a business and you make $15 after taxes in an accounting period, the rate of return on invested capital, as I compute it, is 15 percent. I don't care what it is overnight; I care what it is over an accounting period, over a year's period of time.

WEEDEN: If you want to relate such figures to ours, we carried inventories over the last twenty years averaging three or four times our capital. But if you want to take it overnight, then it is one-third.

FEUERSTEIN: Actually, it should be pointed out, Sy's figures are not return on equity, but return on total positions. If, in fact, a specialist had a 100 percent annual return on positions, assuming that he operated on 10 percent margin, that would amount to a 1,000 percent annual return on equity, before interest costs.

HELLER: Right, but the response to this question, a key question, is, Aren't you as a businessman interested in the return on your invested capital, figures for which are available for the specialist system as well as the third market?

MCQUOWN: And the answer, I think, is on the order of 1,000 percent.

HELLER: No way. The answer on the figures I looked at—reported to the SEC, and I'm not defending the New York specialist—were somewhere around 15 to 20 percent on invested capital.

SMIDT: You made some statements about what is taught in a business school about how to figure return on investment. Since I have spent a good part of my professional life teaching students in business schools how to compute return on investment, I can assure you that the figures we produced at the SEC were the kind of figures I would expect an intelligent businessman to produce, or at least as nearly like that as I could make them. I was very cautious about not allocating costs when there was no rational basis for the allocation. I don't want to try to give a figure that is comparable to what Don gets because I really don't have enough data. But I am prepared to stake my professional reputation on the basis of that data; and knowing something about the other costs, I say that those were monopoly profits. Any reasonable person who had any experience in market making, who had an opportunity to make those kinds of profits, would be very happy indeed to get into that kind of business.

HELLER: Sy, all I can say by way of response is that the figures are available for New York specialists. I have looked at them; Commissioner Loomis, I assume, has looked at them; and they do not run in that magnitude.

SMIDT: Where are they available?

HELLER: At the Securities and Exchange Commission.

SMIDT: In what report?

PAINTER: Perhaps Commissioner Loomis could clarify this point.

LOOMIS: I am afraid I am utterly confused. I have not seen figures of 1,000 percent. I have seen figures computed in various ways, but I really do not think we have a real figure for the specialist's return. I know the exchange comes out with figures. I am not an economist, and I do not know how to get to where they are.

FARRAR: Are there publicly available figures on returns by specialists, other than those in the Institutional Investor Study Report?

LOOMIS: I have never heard of them.

HELLER: The New York Stock Exchange has submitted data to the Securities and Exchange Commission which deal with the New York specialists who do not do a public business. I do not want to recall the figures from memory. I have looked at them for a three-year period of time, and from memory the rate of return on invested capital, which we will define as including all subordinated capital, is in the magnitude of 20 percent after all expenses.

SMIDT: Including their imputed salaries?

HELLER: Including reasonable compensation.

SMIDT: Anybody could make the salaries high enough and define the capital base broadly enough and add sufficiently large accrual items to make the returns low enough to appear reasonable. That would not be a reasonable way to calculate return on investment, however.

LOOMIS: Those are the kinds of concerns I have, so I do not want to underwrite them as SEC figures, because I do not understand them.

PAINTER: I would like to turn the discussion to another rather interesting point. Namely, if you combine the third market with the markets being made by the exchanges, with the specialists on the exchanges, and if the specialists are, at least on the New York Stock Exchange, precluded from dealing directly with institutional investors by Rule 113, will it also be necessary either to impose a counterpart of Rule 113 on market makers such as Don Weeden in the third market, or do away with Rule 113 itself? Does any member of the panel wish to comment on that question?

FEUERSTEIN: It seems to me, the solution to the 113 problem depends upon the type of structure you wish to have for market making in the central market system. Rule 113, as presently designed, serves two purposes. The first purpose is to prevent market makers from having an incentive to manipulate their market in order to facilitate large institutional orders. The other purpose of Rule 113 is to preserve the institutional commission business. This rests on a theory that if institutions were allowed to have direct access to market makers, they would do so in many cases to the exclusion of broker-dealers who presently receive commission business for doing so. Now, the other side of the Rule 113 problem is that the essence of being a market maker, and trading against the market, is knowing more about supply and demand than other market participants. This places the dealer in a better position to distinguish between temporary imbalances that arise because of the irregular flow of orders to the market and imbalances that arise because of more fundamental factors. If a market maker attempts to buy stock when there is an imbalance of supply over demand because investors think the stock is overpriced, he is not going to do anything but lose money. On the other hand, if he buys stock when there is an imbalance of supply over demand because there just happened to be more sellers today, and tomorrow there will be more buyers, he is going to make money. In the original days of the New York Stock Exchange, when the market was basically individual, supply and demand were represented by the specialist's book. To the extent that he knew what was in his book, and nobody else did, he had superior knowledge of supply and demand on which to trade. Today, the real supply and demand situation is no longer on the specialist's book. It is in the intentions of people like the institutional traders in this room. Unless the market maker is able to talk to them and figure out what they are doing or would like to do, he is not going to be in a position to make a market in any depth. That is the Rule 113 problem.

Now, there are two ways, I think, to solve it, assuming that we want to have markets in depth. One is to eliminate Rule 113 entirely, allowing all market makers to deal directly with institutions. The other alternative, which was recommended by the SEC's block trading committee, is to recognize that there are two different functions involved in market making.

One is the institutional market-making function, and the other is the retail market-making function. The second is essentially an administrative function of keeping an orderly hundred-share market, intervening in that market in small degree from time to time, and keeping the book. If it is decided that you want to separate those two functions, then it is possible to have a specialist who does not deal directly with institutions, but who also does not have very great in-depth responsibilities, and upstairs market makers, or backup market makers—whatever you want to call them—who *do* deal directly with institutions and *are* expected to make markets in depth. In my opinion the one alternative that is not possible is to have in-depth market makers to whom Rule 113 applies.

NEWMAN: I disagree with Donald 100 percent on this issue. I believe that it is possible to make in-depth markets *and* provide continuity in 100- and 200-share markets, and I think my firm does so.

I can speak only for my firm and my partners on the discussion of Rule 113. If Rule 113 were removed and Salomon Brothers; or Goldman, Sachs; or Merrill Lynch decided to compete with us because we had the ability to communicate with institutions directly, the possibility of our building a distribution network to compete with them would be virtually impossible, due to the cost involved. One thing I can say, and it is only a humorous aside: I think if that happened I would ask for my old job back at Salomon Brothers. We do believe that the two functions can work together; we do it now. Donald's argument is that he does not think that is prevalent in too many cases. How can you build a system if it is not prevalent in enough cases to make the system viable? My views are solely those of a partner in Weiss, Peck & Greer.

LEWIS: I have two questions. One, relates to Rule 113: Does it in effect preclude the specialist from speaking to the institution in the case of a position bid? If a position floor broker goes to the floor—and if he goes to the floor he obviously opens a dialogue with the specialist—and says, "I am considering making a bid on 100,000 or 50,000 or 30,000, whatever it is, what can you do?" Is it really the position house or is it the specialist who is talking to the institution?

FEUERSTEIN: I think that is a good point. The specialist does talk directly to the institution today in two respects. One, he does so through firms such as mine. Second, he can talk to them directly, because the New York Stock Exchange has interpreted Rule 113 as not precluding specialists from "communicating" with institutions; they merely cannot do direct business with them. Indeed, the good specialists, who do make in-depth markets, do have direct contact with institutions. That raises a question if Rule 113 is designed to preclude the conflict of interest arising because a specialist knows what the institution is doing. In fact, the specialist is allowed and often does know today what the institution is doing. What purpose does

Rule 113 presently serve, then, except to preserve the institutional brokerage business?

MENDELSON: You two have been talking solely about Rule 113, but I would like to ask Mr. Newman whether he can live with the abolition of Rule 394. If we abolish Rule 394, Goldman, Sachs and Salomon Brothers can be partners.

NEWMAN: I can exist with the abolition of Rule 394, because I feel that the markets my firm makes are competitive and will be as competitive as anybody else can make them. I feel we are well enough capitalized to be competitive with anybody.

WEEDEN: If you, in the central market system, make a competitive market atmosphere, and if you take the book or the responsibility for public orders away from all market makers through a computerized system that would be part of NASDAQ or whatever quotation system you have, what public interest regulatory justification remains for Rule 113, for anybody?

PAINTER: I myself would have difficulty justifying Rule 113 if certain assumptions were made: if we did have fully competitive rates; if we did have adequate competition, or vigorous competition, between adequately capitalized market makers and specialists in different parts of the system. It would seem to me that the force of competition itself would bring to the marketplace the kind of liquidity that you would want to have. I am not sure myself just why you would insist upon retaining Rule 113 in that type of environment.

LOOMIS: I think I agree with that. As Don said, one of the reasons for Rule 113, and perhaps the only regulatory reason, was because of the environment that existed when a specialist, in effect, determined what the price was going to be by his quotes, and the necessity to prevent their manipulation to accommodate or to attract institutional customers. In a more competitive environment that may not remain a problem.

PAINTER: Perhaps this gets us back to the basic question of the effect of the composite quotation system on the regional markets. If Mr. Newman and his firm make the kind of vigorous market that he says he makes, perhaps all the business still would flow to the New York Stock Exchange, and very little would be left for the regionals. In which case, with all deference, we might have to reinstate Rule 113.

RICKERSHAUSER: Isn't it true, in the over-the-counter market, the institution is under a legal obligation to go directly to a market maker?

FEUERSTEIN: No, it is not true. There is one decision by the Securities and Exchange Commission, the Delaware Management case, where the commission held that when an institution, in that case a mutual fund, interpositions a broker in order to reward him for some other service, this is a violation of law. Unfortunately, the staff of the Division of Investment

Management Regulation has gone way beyond that case in trying to prevent investment companies from ever using brokers in the over-the-counter market. With respect to other institutions, the Institutional Investor Study found that those institutions which are not subject to SEC regulation, i.e., pension funds, insurance companies, etc., frequently use brokers in the over-the-counter market. Brokers also are used frequently in the bond market in cases where an institution either does not know the market maker, or does not want to deal with him directly, or does not want the market maker to know who he is or what he is doing. The lesson, however, is that although brokers are used in those situations, they really do not get paid very much, because they are not doing very much.

HELLER: I think that in the perfect world that Don Weeden describes, I would have less trouble with Rule 113. However, in the real world, where limit orders, as at present, are being held by specialists, New York as well as regional, I find it difficult to see where the focal point of the specialist's knowledge, as well as the knowledge of the book, is constructive in terms of his dealing with the ultimate customer or the institution. With an electronic book, of course, where specialists do not hold limit orders, I would see Rule 113 as providing no salutory effects. I think there may be quite different interim steps and final steps.

FARRAR: I conclude from the panel's response to my earlier question that a composite tape does not by itself create a central market system; if so, and if it also is clear that the New York Stock Exchange will not voluntarily enter into the development of a composite quotation system, then I wonder about the viability, or the usefulness, of a combination of the composite tape including all market centers and a composite quotation system that includes only regional exchanges and third-market dealers—indeed, that might include the entire marketplace except for the New York Stock Exchange. Barry Tague is a regional exchange specialist who apparently utilizes NASDAQ and perhaps AutEx to connect his marketplace to at least some other significant marketplaces. I wonder if you could comment, Barry, on the possibility of developing a significant mini central market system, containing all market centers except New York, through such an information system.

TAGUE: I think it probably has been reported already that discussions are moving along these lines. Regional stock exchanges are considering putting together a composite quotation system, in concert I believe, ultimately, with the third market. We want to move as quickly as possible toward some type of composite quotation system. We presently are exploring ways of doing just exactly that in the event that we cannot get New York to go along.

IRELAND: There are only twelve men in this room who are going to be doing what all you gentlemen are recommending. I suggest to you that we, as traders, are looking forward to having all the options in front of us at the time we wish to make a trade. Historically, up to 1958, we generally would use an agent to get all that information. Now we have NASDAQ, AutEx, and Instinet, and we used to have Block Automation System (BAS). We have a great deal of input from brokers who take the time to call us. We also use agents to go to the floor to get information. All we are talking about is one thing, and that is to give us options. When you talk about taking away Rule 113 and doing all the other things, what you really are discussing is the best way to get those options. In this last discussion this afternoon about the composite quote system, we are dealing with an area where there are a great many options. It's just very simple. We are the ones, the traders, who are going to decide how we are going to trade, but you are the guys who are going to set the rules.

TAGUE: I think that, in a nutshell, is why the regional stock exchanges are very anxious to have composite quotations. It gives us a form of exposure that we presently do not have. We are proud of many of our market makers. We think they can be competitive. We think they can be competitive with the Weiss, Peck's. We do not think that our market makers are, in general, as deep and as viable as the New York Stock Exchange specialists; but we will pit a few of ours against them. This is what we want the opportunity to do. We think, just as Mr. Ireland has suggested, when people start seeing viable, competitive markets developing from either the PBW market center, Boston, Midwest, or Pacific, that they will begin to avail themselves of an option they would not otherwise know exists.

SMIDT: I think I have to come back to the subject of subsidies. I failed to say something I should have said, in fairness to the New York specialists' community. Don raised the point of subsidies by large stocks for small stocks. We did not find any evidence of that. There was something that I think you could call a subsidy going on in some cases—if you conclude that a subsidy is present if a person does not make as large a profit as he might have made under the circumstances, and gives somebody else the benefit of it. As an economist, I would call that a subsidy. What we found was that there were some specialists, with respect to their most active stocks, who were subsidizing their customers. From the nature of the activity of the stocks, I would presume, in most cases, that they were subsidizing their institutional customers, and it was these specialists who were providing the best markets. The nature of the subsidy was that they were not getting lower income; they were investing more capital and taking larger risks for no greater income than other specialists were.

HEWITT: Let me ask Barry Tague just one question. You said that if we went to negotiated rates first, that it would eventually do away with the exchanges. That part did not really come out.

TAGUE: Potentially, I said that is a distinct possibility. Obviously, negotiated rates eliminate the need for a stock exchange as we know it. I think the thing I am concerned about is the experiences of our industry where we have negotiated commissions, at the $300,000 level and above. A lot of well-intentioned firms attempted to compete, in the early stages of negotiated rates, with the larger, well-capitalized firms having greater expertise. We are finding that those firms are dropping by the wayside daily. Firms are closing up their institutional trading departments. The big remain; the many have disappeared.

On the other hand, you have in NASDAQ a semblance of a composite quotation system, or central market system, in the over-the-counter market. What has been the result of that? The focus of attention has moved away from the New York Hanseatics, the Singer Mackies, the Troster Singers, the firms that commanded a tremendous correspondent business because of their location, their contacts, etc. It has put the little broker-dealer on the map. It has given him an opportunity to compete in a fashion that he never had before. He does not necessarily have to compete in the same depth as the New York Hanseatics, but nevertheless, he is there and somebody can choose him. I think that is the position of the regional stock exchange. That is why we see the move toward negotiated commissions as aiding the big at the expense of the small and the many. We see the advent of a central market system, or the imposition of the various foundation blocks for a central market system, as aiding the smaller, well-managed regional brokers who we think should have an opportunity to remain and become viable elements of the system.

MENDELSON: I just want to make an observation. Mr. Tague has told us that the securities industry is interested in the central market and that we should reverse the procedure; we should go to the central market first and then to negotiated rates. But I have not seen any great anxiety on the part of the securities industry to implement the consolidated quotation system—to actually use the guts of the central market. It has only been the advent of competitive rates that has pushed the industry in that direction.

TAGUE: There is a lot of truth in what you say. I think we have attempted to move forward in this area in concert. We regional stock exchanges initially felt that you could not go into a composite quotation system, into a composite tape, without the New York Stock Exchange. We finally became frustrated with the prospects, and have now explored ways in which we might do it alone. Obviously, we are smaller; we are not as well capitalized. It is going to take money to implement, and it is going to fly in the face of those regional stock exchange boards where the majority of members represent New York Stock Exchange interests. We have a unique situation in Philadelphia, which I do not think any other exchange has—perhaps Boston might be an exception. The majority of our board members do *not* come from New York Stock Exchange member firms. So I think we can move a little quicker into these areas of competition with New York than can the other regional stock exchanges. We are, in any case, exploring the possibility of going it alone.