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Views from Washington

Panelists: PHILIP A. LOOMIS JR., DONALD I. BAKER, HARVEY A. ROWEN

PHILIP A. LOOMIS JR.: Mr. Loomis is the senior member of the U.S. Securities and Exchange Commission. He is a 1938 graduate of Princeton University, and received his LL.B. from the Yale Law School in 1941. At present, he serves on the editorial board of the *Yale Law Journal*. He is a member of the California Bar and practiced law with the Los Angeles firm of O'Melveny and Myers from 1941 to 1954. In 1954, Mr. Loomis joined the staff of the Securities and Exchange Commission as a consultant. From 1955 to 1963, he acted as director of the Division of Trading and Exchanges; in 1963 he became general counsel, and in 1971 he was appointed to the commission.
DONALD I. BAKER: Mr. Baker is deputy assistant attorney general, Antitrust Division, U.S. Department of Justice. He received his B.A. in 1957 from Princeton University; a B.A. in law from Cambridge University, Cambridge, England, in 1959; and his LL.B. from the Harvard School of Law in 1961. Upon receipt of his law degree, he practiced law in London, England, for one year and then for four years in Boston, Massachusetts. He joined the Antitrust Division of the Justice Department in 1966 as a staff attorney. In 1968 he became chief of the Evaluation Section; in 1971 he was appointed director of policy planning; and in 1973 he became deputy assistant attorney general. His responsibilities include regulated industries appeals, policy planning, and economics. From 1968 to the present, Mr. Baker has been involved in the securities industries proceedings.
HARVEY A. ROWEN: Mr. Rowen serves as special counsel to the U.S. House of Representatives Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce. He

received his B.S. in business administration from the University of California at Los Angeles and his J.D. from Boalt Law School, University of California, Berkeley. He is a member of the California Bar, and practiced law in Beverly Hills, California, before joining the staff of the Securities and Exchange Commission in 1968. While on the commission staff, Mr. Rowen served in the Office of the General Counsel, in the Division of Corporation Finance, and on the Institutional Investor Study. When the Subcommittee on Commerce and Finance began its studies of the securities industry, in August 1971, Mr. Rowen joined its staff.

LOOMIS: This symposium was designed to view the central market system from a particular vantage point—that of the regional exchanges—which makes the view from Washington not as significant as it would otherwise be. In view of that, I will not attempt to repeat the general discussions of the central market system which have appeared in various published statements over the period since 1971. I have even made a couple of speeches about that subject myself in recent times. The general ideal and concept, as distinct from any particular details of the system, were, I believe, foreshadowed in the quotation from the Institutional Investor Study Report that opens and provides a theme for this conference. There is some debate as to whether the central market system originated with the Securities and Exchange Commission at that point or in William McChesney Martin Jr.'s report to the New York Stock Exchange a few months later. At least we led them by a few months.

I will not attempt to discuss the three or four key aspects of the system: the composite tape, the composite quotes, and the clearance and settlement matter, because that would merely duplicate what you will hear later from people who have a closer acquaintance with those particular problems than I do. In fact, that is something of a handicap for my present position. I do not really get into the details, the technology, and the nuts and bolts of some of these problems as much as I would like to, simply because they are being worked on by others.

The basic concept of the central market system is to link together the existing markets, not to create a new market to replace them. Hence we refer to a central market *system*, not to *the* central market. This is a process, not an institution. It is to be an evolution. It will start with what we have now, and it will go on from there. It will not be a finished product created all at once. Some people have suggested that not much should happen until some kind of a turnkey contract for the central market system has

been completed and that people should just do things as they have done them in the past until the magic day when you can come in and turn the key and the central market system will be turned on. It obviously is not going to happen that way. In view of that, there is no assurance as to how it *is* going to evolve, particularly over the long term. I would suspect that, given modern technology, there is no natural law or statutory law which would prevent it from evolving into any particular market form.

Turning to your particular topic, the fact that there always have been regional exchanges does not ensure that there always will be regional exchanges. Rather, this will depend in large measure on what the regional exchanges themselves do, as well as what the securities industry itself does. Perhaps a little historical background concerning the regional exchanges would be pertinent here. The regional exchanges started many years ago. They were created to trade locally in local securities. There was a necessary place for them in that process, both because technology did not make it possible to execute orders conveniently from a long distance and because securities were more localized in each region. People were interested in local securities, and they obviously traded them locally. Neither condition now exists nor has it existed for a good many years. The regional exchanges do much of their business in securities of national interest which also are traded elsewhere in the country, particularly in New York. Consequently, some critics have suggested that the regional exchanges, or at least some of them, have survived by offering a means to escape the rigors of the fixed commission rate and other practices which people desire to avoid. This basis of survival, so to speak, will no longer be available to the regional exchanges. Regional exchanges can, of course, and will continue to trade local securities; but particularly in the last decade or so, they have encountered increasing competition in that area from the over-the-counter market. In any event, that is not what we are here to talk about today. We are talking about the central market system or, as the members of Congress seem to prefer, the national market system. I am not quite sure what that distinction in terminology means—and I am personally of the view that it does not mean much—because the central market system concept embodies the idea that orders will be brought together for execution no matter where they originate.

The national market system means that it is national in extent and not limited to a single city. That, I think, is very important and is why we are here today. This does not mean that I do not think the regional exchanges can or should survive. I think they can, and I certainly hope they do. I hope so because there is an important national policy involved in preserving, perhaps not so much a particular floor or floors in some building, but in preserving regional financial communities and in particular regional brokers and regional dealers. However the hardware may be centralized, the people should

not be. But there are certain other considerations and problems. The regional stock exchanges should survive if they carve out a niche for themselves, if they provide a useful service in the central market system. I think this will depend to a significant degree on their making competitive markets and devising innovative services for investors. as many of them have done in the past. If the regional exchanges are to take their proper place in the system, they must be given a fair chance to show what they can do. If they are given that chance, then in large measure it is up to them to do what they will with the opportunity. But trying to make sure that they have that chance involves some difficult questions and choices, since investor interests, particularly in the long term, must—at least from where I sit—come first.

Before coming to these issues there is an important threshold question to be addressed, assuming the desirability of a central market system. How do we get there and when and who will move it along? In this month's issue [November 1974] of *Fortune* magazine, the commission got a considerable going-over. The main theme of the author was that we were attempting to do things that we were not competent to do and which, in any event, should be done by the private sector. The central market system is his prime example. He seems to think that we should just forget about the central market system, initiate competitive rates promptly, right on schedule, and let nature take its course. I do not think that we can leave it at that. But we do not wish to design or to impose the central market system. We believe this should be done by the private sector, subject to our scrutiny, or oversight as the congressional people call it, and our intervention where necessary. But the process seems to be going rather slowly. The Washington *Post* headlined an article on the subject last week: "The Central Market Crawl." This is, I think, unfortunate. Although I appreciate the fact that insofar as the creation of a central market system involves outlays of cash, which is not too plentiful in the industry at the moment, the industry can reasonably say that they would want to see an opportunity for a return on the dollar so spent. But aside from this problem, which I do not think is overwhelming, change is coming, and if the industry does not shape the change, the change may shape it in a manner which it might not like.

In this connection, I will not talk about competitive rates because that subject is involved in hearings we are now holding. Coming back to the basic question, the rules to be developed for the central market system will affect the place of the regional exchanges in it, very obviously. This brings up the slogan of "equal regulation," which sounds so reasonable but may need a closer look. I once collected some notoriety by saying that equal regulation of the unequal is inherently unequal. Yet in some areas, equal regulation in the central market system is necessary. To illustrate, there is regulation of short selling on the New York exchanges and prohibition of manipulation. These have not been major problems on the regional exchanges, at least as to duly

traded issues in the past. The reason is that basically both bear raids and most manipulations succeed only if they give a false appearance to the market and thus influence and cause trading by others. This was not very easy to accomplish on a regional exchange while the public was not looking. The composite tape and the composite quotation system will change that. What happens on a regional exchange will be visible from coast to coast and overseas. Hence, equal regulation is needed here. Regulation of short selling in a multiple-market system involves difficult problems and might call for a whole new approach in place of the traditional reliance on the latest print on the tape, particularly as I understand specialists never look at that anyhow. Industry people and self-regulation are making a diligent, good-faith effort to deal with that problem promptly and effectively, and I think they will succeed.

The regulation of specialists and market makers is a different and a key problem. I will not attempt to explore that subject in depth, partly because time will not permit. I think, however, this is an area where thoroughgoing equal regulation would be unequal, at least for now. For example, specialists on the New York Stock Exchange and on the American Stock Exchange have been prohibited for a decade from dealing directly with institutions. There were good reasons for this. In my recollection, which may conflict with some other people's version, this grew out of an investigation of the American Stock Exchange in 1961 and 1962. It was found that specialists on that exchange engaged in a number of different kinds of preferential, if not illegal, deals with issuers and institutions. The monopoly position of the specialists made this possible and dangerous. Third-market makers deal with institutions, and for some this is the major part of their business. This has not resulted in abuses of power, because they had no monopoly. I do not think that the New York Stock Exchange Rule 113 can or should be applied to third-market makers. Possible application of such rules to regional specialists is a very live issue, and I will not attempt to forecast the answer to it now.

The aspect of specialist regulation that has been most difficult and important, and to some extent unsatisfactory, over the years has been, in my opinion, the affirmative obligation of specialists to make an orderly market when there is a significant imbalance of supply and demand. This is a basic attribute of the specialist system and has often been cited as its cardinal virtue. It has also been the most difficult to enforce effectively and the area in which performance has been most uneven. Here the good specialist is separated from the bad one. It has sometimes seemed to me, after a rather frustrating acquaintance with this problem, particularly in my years in the Division of Trading and Exchanges, that no amount of regulation seemed to make all specialists good specialists, simply because good specialists quite often lose a considerable amount of money when the going is tough and people do not like to lose money. One of the major

reasons for the central market system is to introduce competition into this area, with the thought that competition will produce better specialists than regulation does, because the good specialists should, in an ideal world, get the orders. One of the major questions which will have to concern us all is whether the system will work so that the good specialists do get the orders; or whether habit, tradition, the easiest way of doing things, or indifference to best execution will lead brokers to send their business where it is most convenient for them rather than to the best specialist, from whom their customer would receive best execution. That, I think, is something I would hope this conference would focus on because I do not have the answers to it. Regulation often effectively prevents people from doing what they *should not* do, but it is less effective in making them do something they *should* do.

Returning just for a moment to the legislation, which is Harvey Rowen's province, all I will say is that I hope and believe that it will pass and that all influences that can be brought to bear to get it done now would be in the public interest. In that connection, I may note that the Midwest Stock Exchange led off our hearings on competitive rates, Tuesday [November 19, 1974]. They took the position that they favored competitive rates but for various reasons, well articulated in Michael Tobin's [president, Midwest Stock Exchange] testimony, not until a reasonable period after the legislation had passed. He said, somewhat optimistically, that the industry could go over to competitive rates without difficulty two months after the legislation is enacted but that it cannot go over to it before the legislation is in hand. If we attempt to go forward this spring without the legislation, a disorderly progress is quite likely to occur. Don Farrar has a very nice, neat time schedule as to the order and time in which everything should happen. I tend to subscribe to it; but if we do not get the legislation, we may not have that kind of progress because some phases of it will, if nobody objects to them, come in before other phases that some people do not like. Some things will be tied up in the courts, and in general, people will not know where they are going. The SEC sent a letter to the chairman of the House Committee on Interstate and Foreign Commerce, and to the ranking minority member, stating its belief that enactment of the legislation in this Congress was essential to the avoidance of delay and confusion, and to enable the commission and the securities industry to go forward with assurance into the future for the public interest. I hope that will occur.

BAKER: Churchill said in 1945: "I did not become His Majesty's First Minister to preside over the liquidation of his empire." That comment told us a lot about Churchill—but very little about the ultimate disposition of the empire. The fact that the empire was a useful nineteenth century institution did not guarantee its survival in the mid-twentieth century.

Today, in the securities industry, we also are being treated to a great deal of picturesque but irrelevant rhetoric in the same vein. It can be heard in

congressional corridors, at Securities and Exchange Commission hearings, and almost anywhere else where a few reporters can be gathered together to receive the word.

Tradition can blind us to truth. The truth is that securities markets exist to serve the investing and issuing public, rather than to serve broker-dealers. The "private club" way of life dies hard, but it is dying nevertheless.

The success of a capital market in serving the public is measured in three essential ways: by best market price, by lowest transaction cost, and by fullest disclosure. This means that business should flow to dealers who make the tightest markets and to brokers who are most efficient in searching out the best deal.

Historically, our securities markets have been quite different. They have been studded with barriers designed to protect ancient privileges. Commission rates have been fixed to protect the value of members' seats, and trading in other markets has been restricted to protect the value of the specialists' books. When even more ingenious minds were able to circumvent these barriers with a rebate, a four-way ticket, or a PBW Stock Exchange membership, government was called in to rebuild the barriers and save the ancient privileges.[1]

However, things have changed markedly in the past two years. Computerized communications technology has eroded the old barriers at an ever quickening pace, and government has shown little interest in resurrecting them. The New York Stock Exchange might wish to retain fixed commission rates and eliminate the third market, but it is not going to be allowed to do so. It might like to perpetuate its position by asserting "proprietary" rights over public data, but it is not going to be allowed to do that either. Those are the facts of life.

The Department of Justice has been an active advocate of change for at least six years. Once we were the lonely challengers of fixed rates, Rule 394, and similar barriers, but now we have been joined by a vigilant commission and an interested and active Congress. All seem intent on eliminating the old barriers, on opening the way to a new world in which rewards are tied to playing skill, not the color of the player's shirt. A true central market system would do exactly that: it would allow me to choose between brokers on the basis of price and quality of service, and it would allow my broker to choose between all auction and dealer markets entirely on the basis of the price and terms of execution available in those markets. Such a life may be less comfortable than life in a private club, but it is more likely to weed out the deadwood, reward the truly skilled, and generally give the public greater confidence in our capital markets.

Eliminating the ancient barriers is, of course, vital if we are ever to have a free-flowing central market; it requires drive, determination, and the plodding hard work necessary for successs in trench warfare. Designing a

more flexible future is even harder; it requires imagination, an appreciation of changing technology, and an ability to resist special interest pleas of doom.

The trench warfare process is well illustrated by the painstaking process of eliminating fixed rates. After thousands of hours of SEC and congressional hearings—which have failed to show that a classic price-fixing cartel is necessary to serve the public—the SEC is having to crank up still another round of hearings to compel the exchanges actually to eliminate the practice. This last hurrah before the commission is likely to be followed by court challenges as a means of postponing the day of reckoning. Congress may short-circuit this process by enacting a statutory termination of fixed rates on May 1, 1975. H.R. 5050 includes such a provision.[2]

Congress also may have an important hand in the broader central market development. As you know, the SEC has shown commendable vision in working toward a free-flowing central market system as essentially a communications system by which various exchanges and market makers are tied together for the purpose of rapidly exchanging quotations, orders, and completed transaction data. Unfortunately—but not surprisingly—the New York Stock Exchange has seen the development of such an effective system as a threat to its historic primacy in the industry; and, accordingly, it has resisted that development in a variety of ways. Among other things, the exchange has insisted that it has a "proprietary" right over quotation and transaction data from its floor; and, as compensation for these "rights," it apparently seeks a privileged position in the new system. This would of course be highly undesirable. Fortunately, Title VI of H.R. 5050 would give the SEC additional authority in this area and provide it with an even stronger basis for rejecting the NYSE's claims of "proprietary" rights.[3]

We in the Department of Justice have been particularly concerned that the new central communications institutions of the central market not come to be dominated by the self-regulatory organizations which have dominated the marketplace in the past.[4] Central processing may turn out to be a monopoly function, because it turns out to be characterized by pervasive long-run economies of scale. If it does—and it is by no means clear that it will—than it will have to be organized in such a way that all broker-dealers enjoy nondiscriminatory access to and benefits from it. Such a monopoly institution might require public-utility-type regulation by the SEC to avoid overcharges and other abuses, and this could be done more effectively if it were not dominated by a single exchange or sector of the brokerage community.

Beyond that, the commission should leave the door open as wide as possible for competition in the central processing functions. Even if competition were not now possible, it might become possible with future technology. Competitive central processing would be preferable to

monopoly, because it would avoid the need for utility-type regulation and would allow the competing central processors to vie with each other in developing new communications techniques. This is very much the same type of technological and commercial competition that we see between two national bank credit card systems, BankAmericard and Master Charge. The president of BankAmericard has stressed that such competition is worthwhile and works, and that systems costs are quite manageable. Shortly, BankAmericard will start using a nationwide electronic clearance system to process 200 million credit card items per year. "The entire system . . . costs less than $7 million, including central computers, 90 mini-computer-type transmission units used in member centers, central software, edit software for member banks, audit procedures, training and operating manual and customer educational materials."[5] This system will cut existing unit costs over 70 percent. It offers a relevant message for the securities industry, which ought to have central processors with higher volume and potentially lower unit costs.

I happen to think that an open, free-flowing central market system is something that regional exchange members ought to welcome. With quotations from all markets, transactions possible on all markets, and full reporting, others need not operate in the shadow of New York. The Pacific or Midwest member broker should have the same information and the same opportunity to seek best execution, and the same opportunity to get paid for doing a better job. Such competition should reduce costs and brokerage rates, and thereby increase trading and liquidity. It is a game the skilled and energetic should welcome (and of course it is a game those who lack these skills should think of getting out of!).

The future of the industry lies very much with those of you in it. Even in Washington, we are coming to realize the importance of the point made clearly by Donald Weeden, namely, that "competition and innovation are more important to this over-structured industry than any proposed new legislation or regulation."[6] We cannot legislate or order innovation and competition. We can, however, legislate and order the elimination of legal and self-regulatory barriers to these values.

I could not as a lawyer and a law enforcer underscore more forcefully the point that Phil Loomis just made a moment ago about the difficulty of ordering people to do something they don't want to do. There is a classic case in the equity jurisprudence dealing with an opera singer in the nineteenth century who broke her contract with the plaintiff and left him square in London. He went in and said, "Make her sing;" and the chancellor said, "I can't make her sing. I'll order her not to sing for anyone else, but I won't order her to sing here." We have this continuing problem, particularly with the obligation to make orderly markets. I think, from a legal standpoint, we have to go to designing systems that work more on the basis of carrots and

less on the basis of sticks. As one who spends his time wielding sticks, I assure you there is frustration often enough to affect you.

At the moment, there seems to be a broad consensus among the commission, the executive branch, and the Congress on this immediate issue. This is a consensus in favor of competition. It is reflected in the House and Senate securities studies;[7] in the Securities and Exchange Commission's releases on central market system and fixed rate issues;[8] in the Treasury paper on the future of capital markets;[9] and in the Justice Department filing and testimony.[10] This is encouraging and important—especially as a message for those who revere the past and dream that Mayday will never come in 1975.

The commission deserves special praise for the way it has pressed on firmly, despite many terrifying screams from those whom it regulates. This performance is particularly visible because it comes at a time of clear (and justified) public dissatisfaction with the way many federal regulators have performed in the past. The nub of that public criticism is that the regulators tend to listen too much to those whom they regulate and not enough to independent and consumer voices, and that, as a result, regulation tends to become a vehicle for suppressing competition and protecting vested interests. Happily, today's SEC escapes that criticism, and indeed is held up as a model of vigorous and independent regulation.

One has only to contrast a couple of newspaper headlines of the past couple of months. One from the *Wall Street Journal*, August 13, 1974, reads, "Friendly watchdog—CAB is Enthusiastic Backer in Moves to Trim Airline Service, Increase Fares." I contrast that with one from the Washington *Post*, October 20, 1974, which reads, "SEC Marks 40th Birthday with Industry Its Biggest Critic." I guess the message is there. If you do not have the Justice Department criticizing you the industry will step into the gap.

Current success, admirable as it is, should not blind us to long-term realities as we put together legislation designed for the long term. The long-term reality is that regulatory decisions will be able frequently (but not always) to exercise very considerable influence over the appointment process, and how the whole scheme works.[11] This has often been true of the SEC in the past. Faced with a dominant and determined adversary, the commission has rarely used its formal statutory powers on economic questions, preferring instead a process of informal bargaining and compromise.[12] This in part explains why the historic restrictions have held on for so long.

In the future, we can often expect to have a commission far less independent, determined, and innovative than the one we have at the moment. This is just what one might call a political law of averages. It may be good news for parts of the industry, but poor news for the public.

What this means is that we should be very chary about handing the SEC "blank check" grants of statutory power over competitive questions. The commission should have the full and complete power necessary to *tear down* the old barriers to competition (such as fixed rates and NYSE Rule 394).[13] It should not be given broad powers to *resurrect* those barriers or similar ones at some unspecified time in the future. It is easy to say that "the present commission would never do anything like that." This is not the point. With the power present, some future commission might do so—and the presence of broad SEC powers to suppress future competition will tend to invite future political efforts to secure appointment of commissioners who will exercise those powers. Unfortunately, the presently pending bills (particularly H.R. 5050) do contain just this type of open-ended grant of authority to the SEC on key competitive questions—including resurrection of fixed rates and suppression of the third market.[14] The Department of Justice has opposed these particular provisions,[15] but they have so far survived the cut and thrust of legislative compromise.

What makes the legislation still highly worthwhile, despite these compromises, are the provisions on the central market system. H.R. 5050 gives the SEC an even stronger basis for resisting the claims of "proprietary right" over data necessary to the system. By eliminating this barrier, the legislation goes far toward assuring that we will have a fully open and fair central market system, free of special preferences and protections. Such a competitive and innovative environment may be expected to produce great forward momentum for lower costs and far greater diversity in how the public is served. Once the program has started rolling, it may make change irreversible, and thus the ancient barriers and battles may be left far in the past, where they belong.

NOTES

1. SEC Release 34-9950 (January 16, 1973), adopting Rule 19b-2 under the Exchange Act.
2. H.R. 5050 (Committee Print, 93rd Cong., 2nd sess., August 13, 1974), §202, amending 15 U.S.C. §78F.
3. Ibid., §601.
4. See *Comments of the United States Department of Justice, on Proposed Rule 17a-14* (filed September 30, 1974).
5. D. W. Hock, "EFTS or EVE," (address delivered in Melvin Village, N.H., October 7, 1974).
6. Donald E. Weeden, "Investing in Reform and Gambling on Change" (address delivered in Washington, D.C., October 23, 1973).
7. House Committee on Commerce and Finance, *Securities Industries Study*, 92nd Cong., 2nd sess., 1972; Senate Subcommittee on Securities, *Securities Industries Study*, 93rd Cong., 1st sess., 1973.
8. See SEC, "Policy Statement on the Structure of a Central Market System" (1973); SEC Release 34-11073 (October 24, 1974), proposing adoption of rules 19b-3 and 10b-22.

9. U.S. Treasury Department, *Public Policy for American Capital Markets*, prepared by James H. Lorie (Washington, D.C., 1974).
10. Comment of the U.S. Department of Justice to the Securities and Exchange Commission on Intra-Member Commission Rate Schedules of Registered National Securities Exchanges (June 1974).
11. See, for example, Louis M. Kohlmeier Jr., *The Regulators: Watchdog Agencies and the Public Interest* (New York: Harper & Row, 1969).
12. See Note, "Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange," *Yale Law Journal* 80 (1971): 811.
13. The Department of Justice has consistently indicated that the commission has adequate authority under Section 19(b) of the Securities Exchange Act to eliminate fixed rates and other similar restraints. See, e.g., *Memorandum of the United States Department of Justice on the Fixed Minimum Rate Structure*, File No. 4-144, pp. 15–42 (filed January 17, 1969).
14. H.R. 5050, §§202, 601: compare S. 2519, §11a(m).
15. Letter dated September 19, 1974, from Assistant Attorney General W. Vincent Rakestraw to Honorable Harley O. Staggers concerning H.R. 5050.

ROWEN: In the beginning, there was H.R. 5050. H.R. 5050 is the result of a study conducted in the Ninety-second Congress by the Subcommittee on Commerce and Finance. That study, in turn, grows out of the passage of the SIPC [Securities Investor Protection Corporation] legislation in 1970. The legislation now has passed the subcommittee, has been reported by the full committee, and is awaiting a rule to go to the floor of the House for action; then to conference with the Senate. The Senate has passed three bills which, taken together, pretty much parallel H.R. 5050.

As you might expect, there are those in the securities industry who are opposing the bill. They are attempting to throw a little sand in the gears of the machinery to slow things down just enough so that time will run out before the Congress expires January 3. My own best estimate is that they are not going to be successful in this endeavor, but I think the next six weeks will prove to be very interesting.

In addition to the three bills I mentioned—the numbers if you are interested are S. 470, S. 2058, and S. 2519—the Senate also has passed a bill, S. 2474, providing for regulation of municipal bond dealers. There is no comparable legislation in the House of Representatives. In addition, both houses have pending before them bills that require institutional investors to disclose publicly and to the SEC on a periodic basis their securities holdings and transactions under certain specified circumstances. The goal is to take all of this legislation, wrap it up into one bill during conference, pass it, and then send it on to the President for enactment. What the final bill will look like, of course, depends a great deal on what the principals, that is the senators and the congressmen who are on the conference committee, decide about areas of disagreement.

Let me give you an idea of what I think will be included in the bill and

then touch on areas where there still are decisions to be made. I believe the final bill will contain a statutory provision eliminating fixed rates as of May 1, 1975, but will give the Securities and Exchange Commission some degree of flexibility to adjust that date if the commission feels it in the public interest to do so. That is one of the provisions that Don Baker of the Department of Justice is less than delighted with, but I think it will stay in the bill as it comes out of the conference committee. The bill, I think, also will contain a provision, found in slightly different forms in House and Senate versions, prohibiting exchange members from transacting any business with an affiliated person—the so-called 100-0 test. There will be certain enumerated exceptions and exemptions to that test which are too complicated to get into now. Basically, that test will replace the SEC's current 80-20 rule mandated by their Rule 19b-2 under the 1934 Securities Exchange Act. The 100-0 test, as a practical matter, should eliminate most institutional membership from stock exchanges. Institutions have joined in the past as a method of recapturing fixed commissions by having affiliated brokers do portions of their own business for them. This will prohibit that. To me it appears a rather cumbersome method of eliminating institutional membership, as I think the elimination of fixed rates will, for all intents and purposes, remove the principal incentive for institutions to seek such memberships. For some reason I still cannot understand, the industry wants that provision in the bill, and I think we probably will see it enacted. The bills will also give the SEC clear authority to facilitate the creation of a national market system. It will give the commission authority to implement the consolidated transaction tape and composite quotation system, both of which you will hear about in much greater detail as the symposium progresses.

Let me only say now that we believe the commission already has the authority to do what they are doing, but that legislation will make this point absolutely clear. I think the bill also will contain some version of the institutional disclosure acts that now are pending in the House and Senate. Again, there are differences as far as cutoff limits, numbers, and things of that sort; but I think we will work out a reasonable compromise.

There are areas where disagreement remains and where it still is not clear how the principals will resolve the differences. The one that seems to be the current game in town is "paying up" for research. Both the House and the Senate have provisions which say, in effect, that a fiduciary money manager will not breach his fiduciary obligation by paying something more than the cheapest commission then being charged in the securities industry. The House believes that this clearly already is the law and should remain so; that the fiduciary has a duty to choose a broker he thinks can perform a valuable service for his beneficiaries and pay him a reasonable fee for those services, even though there may be another broker down the street who charges less. The Senate has a provision that does not go quite

that far. How these two provisions will be ironed out in conference is too difficult to foresee right now.

H.R. 5050 also contains a provision directing the SEC to conduct a study of the activities of banks in the securities industry, and next year to report to the Congress their findings, conclusions, and any recommendations for legislation that may emerge from the study. The securities industry has been troubled for some time by the growing involvement of banks in their industry. The industry would like the SEC and the House Commerce Committee, I think, to become involved in this, not trusting the committees of Congress that have jurisdiction over banks, which may be less bothered by this intrusion. Senator Williams [Harrison A. Williams Jr., New Jersey] has announced that the Senate Securities Subcommittee of the Senate Banking Committee will conduct that kind of a study in the next Congress. We are not sure how he views this provision in H.R. 5050—whether he views it as an intrusion upon his announced study or whether he is willing to do his study in conjunction with the SEC. We have not gotten a reading on that yet, so it is a little early to say whether or not that provision will stay in the final bill.

There also is a provision in both H.R. 5050 and in S. 2519 that would give the commission authority, under certain specified circumstances, to limit trading of securities to exchange markets. This is the provision with which I believe the Department of Justice is most unhappy; since this provision appears in both Senate and House bills, however, I'd expect some form of it to emerge from the conference. Exactly what form it will take, again, is not now clear; they are cast in somewhat different ways. H.R. 5050 also eliminates, by statute, New York Stock Exchange Rule 394. That rule, we believe, makes it virtually impossible for a member to take a customer's trade off the exchange for execution, even if doing so would provide the customer a better execution. The Senate bill does not contain comparable language. Again, we will have to await the conference to see how this matter is resolved.

Finally, as I mentioned, the Senate has passed a bill regulating municipal bond dealers. The House not only does not have a comparable bill, but has held no hearings in this area. The Senate would like to see that bill incorporated into the final conference document. The House traditionally has been reluctant to do that where it has held no hearings and has no record of its own on which to accept the Senate bill. On the other hand, the SEC feels that provision to be important to the public interest, pointing out recent abuses in the area. Again, I think this matter will have to await resolution in conference.

Assuming that all these matters are passed between now and January 3 and the President signs the bill, and we expect him to do so since the Administration is supporting the bill rather strongly, I might just give you

some brief insight into what will be cooking in the Ninety-fourth Congress. We need something to do between the time that H.R. 5050 passes and the time that Louis Loss and his committee send us their comprehensive recodification of the federal securities laws. What we had hoped to do this year, and never got a chance to do, was to take a look at specific legislation. I see Mr. Wedbush [Edward W. Wedbush] is here. His firm has been very active in trying to obtain increased SIPC coverage, particularly for regional brokerage firms. One of the recommendations of SIPC, in a report issued a few months ago, was to increase coverage of SIPC insurance. This may take care of Wedbush, Noble's problem; and, I think, assuming 5050 passes, that will be the first area to which we will turn during the next Congress. Mr. Moss [Hon. John E. Moss] also has indicated an interest in taking a look at the Investment Advisers Act, in light of his belief that when investors do return to the marketplace, and he thinks that will happen some day, they may very well turn to professional managers for help in their affairs and that, perhaps, the Investment Advisers Act needs strengthening.

Finally, the Securities and Exchange Commission has recently put out a package on mutual fund distribution. Part of that package indicated that they will send to the Congress proposed legislation concerning Section 22d of the Investment Company Act of 1940, concerning retail price maintenance. We will, of course, be happy to receive those proposals, and introduce them as a matter of courtesy. We will then take it up in some detail, in due course. Those, I think, pretty well cover the specifics of where we are. Tomorrow, Mr. Moss will be here to talk about policy and to answer any questions you may have. And of course, to the extent that you have questions today, I will be happy to be as responsive as I can.

OPEN DISCUSSION

Other participants, in order of initial comment:

James E. Dowd
Boston Stock Exchange
Donald M. Feuerstein
Salomon Brothers
Peter Grose
New York Times
Donald E. Weeden
Weeden and Company, Inc.
William H. Painter
University of Illinois

David L. Ratner
Cornell University, Law
Donald E. Farrar
University of California, Los Angeles
Morris Mendelson
University of Pennsylvania
Robert R. Glauber
Harvard University
John P. Shelton
University of California, Los Angeles
J. P. Guerin Jr.
J. P. Guerin & Company
Richard Servetnick
American Express Company
Thomas J. Lewis
Josepthal and Company, Inc.
Mark B. Garman
University of California, Berkeley
William D. Ireland
Bank of America
John A. McQuown
Independent financial consultant
Richard R. West
University of Oregon
Charles E. Rickershauser Jr.
Munger, Tolles, Hills & Rickershauser
John Jenkins
B.N.A. Publications, Inc.
Robert M. Newman Jr.
Weiss, Peck & Greer
Marvin Greene
Loeb & Loeb
Donald L. Calvin
New York Stock Exchange

DOWD: I would like to direct a question to Harvey Rowen. He mentioned that, in his opinion, one of the provisions of the omnibus bill as it emerges from the conference committee might be a position dealing with the fiduciary's right or ability to "pay up" for research. I know the commission had an all-day conference, including many segments of the industry, which came to no conclusion as to whether a federal provision would satisfy nonfederally regulated fiduciaries. Do you have any personal opinions as to how far a provision in a bill such as 5050 would carry to, say, a state bank or a state-administered pension fund?

ROWEN: Our bill specifically pre-empts state law on this subject. There

is an out clause which says, if the states do not like this federal policy, they may, by statute, reverse it and pass a law in that particular state which says we cannot do this, we have to do it some other way. But the bill as drafted does pre-empt state law to a considerable extent on this subject.

FEUERSTEIN: Harvey, on the same subject, one of the big issues of debate at the SEC conference was whether it is appropriate to pay up on an execution for account A to purchase research for the sole benefit of account B. Does the House legislation deal with this question? The Senate legislation, I know, specifically says that the paying up must be on commissions for the same account that received the research.

ROWEN: No, the House legislation does not address the so-called allocation question, but simply lays down a broad standard that a fiduciary money manager has to use reasonable business judgment in paying commissions to brokers and that a complaint does not state a cause of action by merely alleging that a fiduciary paid more than he would have had he used the broker down the block. The complaint must allege something more.

FEUERSTEIN: Well, if the legislation does not deal with that question, it is almost totally worthless. I think most astute trust lawyers would tell you that they have no problem in paying up for research, if the research is in fact going to the account for which the excess commission is charged. The only real problem is the interaccount problem.

ROWEN: That is not what we are hearing, Don. Jon Lovelace and I were talking about this during the break, and maybe "paying up" is not a good way of phrasing it. Jon was talking about the question of whether you have to "pay down." If everyone got to a certain level, and if there are some brokers who are below that level, do you have to choose one of the cheaper brokers? I think maybe it is a semantic problem. I think all the House is trying to do is lay down a broad principle. The specific fact situations are for the courts. If you "pay up" for a trip to the Superbowl, that is one set of facts; if you "pay up" for a broad economic report on a situation in Zambia, and you happen to have a portfolio company that is affected by circumstances in Zambia, that is something else again. Phil was trying to make that distinction at the conference—trying to talk about different types of research product.

BAKER: Then you basically have three situations, I take it. You have a situation where the research you are getting benefits entirely and exclusively the account which the brokerage is going on. Second, which must be the overwhelmingly common one, is that it benefits the manager's accounts generally. The third one benefits exclusively other accounts, but not this one. It would seem to me to be highly undesirable, from the standpoint of public policy regarding fiduciaries, to say to the broker, "You can do it," in the third case. The second case is fine.

LOOMIS: I think the second case is probably the most common one, particularly for some institutions. Many of them tell us they do not look for the brokers to tell them to buy X rather than Y. That is their job. They want more generalized information.

GROSE: I would like to put Mr. Loomis on the spot about his views on the future of the SEC. Would you like to address yourself to Don Baker's expressions of concern as to whether the proposed legislation would give too much statutory discretion to a regulatory body?

LOOMIS: I understand his concern, but it seems to me that it is the essence of the administrative process to give administrative agencies authority to deal with problems as they arise, subject to judicial review. The House committee in particular was very careful to make sure that the courts could take a look at anything we do. Some proposals for legislation would have given to us authority that I don't think we should have, but as the legislation has emerged, I don't think it has done so.

GROSE: Are you speaking specifically of the third-market provision in one of its earlier phases?

LOOMIS: Yes, we were opposed to that. I must say, as I should have done in my earlier remarks, that everything here is just my opinion and not that of the commission, particularly on this topic, on which we may not be entirely unanimous.

WEEDEN: Yes, I wondered if Phil Loomis would speak to the point Don Baker made concerning clearing systems—the idea that you leave open the possibility for competing systems to develop, based on the experience that innovations have come principally from clearing systems in regions outside New York.

LOOMIS: My inclination, at least at the outset, is that we should encourage the creation of more than one system or competing systems if, and this is an important if, the arrangements are such that a complete interface is practicable between the systems, that you do not have any closed situations where a broker has to be a member of two or more different systems. That would be unfortunate. Subject to adequate interface, I would like to see some different systems. I have heard from proponents of one or another system advocating that their ideas are better than the other fellow's idea: it will be cheaper, it will work better. I am not in a good position to make sure that that is so, but I think we should have a chance to try them in practice if we can avoid creating operational problems in the process.

BAKER: What I was concerned about in particular was a time dimension, with changes in technology. At some point competition may become feasible which was not possible before. We have an outstanding example in the Satellite Statute which Congress passed in 1962, based on an assumption that we would have a worldwide system of orbiting satellites,

which would be a natural monopoly. Within two years a fundamentally different system employing stationary satellites had been developed. Such a system did not constitute a natural monopoly; yet we had a statute that had been completely drafted in terms of natural monopoly assumptions. I have been concerned that even if we found there was a natural monopoly now, that we not legally lock ourselves into it for all time.

PAINTER: I would like to pursue a dimension of Commissioner Loomis's previous remark and ask that he extend his observations to the desirability of competing systems for the composite quotation network, or should there be only one composite quotation system?

LOOMIS: Well, my inclination there, and I probably will be enlightened this afternoon, would be for a single basic quotation system. For example, NASDAQ (National Association of Securities Dealers Automated Quotation System) is single; we do not have the two NASDAQs; various organizations are free to plug into that and to provide subscribers with that data in any form or combination the subscribers want.

WEEDEN: Essentially, what Bill [Painter] asked was to take that concept and apply it to the central market system. Does the SEC think that it can design a central market system that is so accommodating of potential improvements and future requirements that they are willing to insist that it be the only system through which all transactions have to take place?

LOOMIS: I would hope not.

RATNER: I am going to try to focus on what the different roles of the exchanges are when we talk about the role of regional stock exchanges in a central market system. It seems to me, you have exchanges as they have developed, performing several different functions. One is to provide an actual facility through which orders meet and transactions are executed. I suppose one question that comes up, that was just raised, is, What part of this function is a natural monopoly? In other words, in what parts of that process is it desirable to have a single system which probably has to be regulated in one way, and what parts of it can you open up to competition? In a way, I suppose, it is similar to American Telephone and Telegraph. Even if you assume the necessity, or the desirability, of a single communications network, it does not mean you must have a monopoly of people making telephone equipment or of those who can transport equipment to it in the end. The problem with exchanges as they had developed has been that they have attached to the market facility a whole series of restrictions on the retail end of their members' business. This aspect of the exchange, as a rule-making entity governing the activities of its members, which is not necessarily tied into the operation of an exchange facility, leads to situations where different people have different rules. Obviously the regional exchanges have grown a lot in recent years because their rules were less restrictive than those of New York, people could do business and gain an

amount of access there that they could not in New York. If the SEC carries through in eliminating fixed rates, and the bill eliminating Rule 394 and other restrictions also is enacted, does any role remain for the regional exchanges as market facilities? In other words, when we talk about exchanges or the role of exchanges, what functions of the exchange are we discussing? Unless you separate them, it is very hard to focus on them.

FARRAR: That appears to be a statement as well as a question, directed to me, perhaps, as appropriately as to any member of the panel. Let me respond, therefore, by stating that in considering the future of stock exchanges, and the future of regional stock exchanges in particular, we are focusing in the symposium principally on their future as facilities for the execution of transactions, or for providing access to a broader marketplace in which trades will be executed, rather than on their future as rule-making bodies or as agencies for enforcing rules laid down by others.

BAKER: I just wanted to piggyback on Dave Ratner's point about the telephone system. It seems to me that as we sit and think about central institutions in the market, quotations, and so forth, they sound like utilities. In fact, what we have is something that is going to use the existing utility, namely, the telephone system. Really what you have in any kind of central market scheme or in a central electronic banking system is two elements. One is a sort of transportation system and the other is the institutional arrangement which uses the transportation system. You may have a natural monopoly in the transportation system without having a natural monopoly regarding the institutions that use it. BankAmericard and Master Charge are rather good illustrations of this point.

MENDELSON: Let me note two things. First, it is not clear to me that you can separate the problem of the regionals as self-regulatory organizations and as trading arenas. It is primarily because they are trading arenas that they have the membership they have and consequently can impose regulations. If you develop a system in which brokers no longer have reason to belong to a regional stock exchange for trading purposes, it is not clear that they are going to belong at all. Some technological advantages may develop, but that remains to be seen.

Second is the question of competition in a central market system. I want to consider situations in which we have automated executions. It seems to me that what the SEC is thinking about is a set of regional exchanges, each of which acts as a focal point for the trading of its own members. These regionals are all to be linked to some central book so that when an order comes into the system, somehow or other, an automatic routing system decides which of the markets is best for that particular order and directs it accordingly. An alternative is the kind that I had suggested, in which we have a monolithic central book and everything goes directly to that book. In that kind of system, I can see absolutely no function for a regional

exchange, or any other kind of exchange. The objection to this concept is that it may lead to technological retardation. Once you have set the system in operation, you have a complete monopoly. There is, however, a third kind of system that might yet work. What is important in setting up a central market is that the market for any single stock should be central—that there be a single focal point at which all orders for that stock come together, so that the best bid will meet the best offer. If you try to set up a system for all the stocks on the New York Stock Exchange, you are going to need a complex of computers. Since that is the case, there is no reason why you can not divide the market up and have one processor bid to make the market for one quarter of the stocks, another processor bid for another quarter of the stocks, and so forth. You have parallel central market systems for different groups of stocks. Competition between the systems may very well keep the technology up to date.

GLAUBER: I would like to direct a question to Mr. Loomis. You have suggested that much of the growth of regional exchanges until now has been based on their ability to provide mechanisms for avoiding the impact of fixed minimum commissions. Quite obviously, the future growth of these exchanges in an environment of negotiated rates will depend on their ability to provide real services for which brokers and investors are willing to pay. What services do you think regional exchanges can uniquely provide?

LOOMIS: Well, I do not know exactly what they would be, but I have a number of ideas in mind. Regional exchanges in the past have devised systems for handling orders, handling back-office procedures which were different, and in some degree better, than those that existed elsewhere, and they have gained by doing that. There is, of course, a basic problem as far as the situation that will arise when fixed rates are eliminated. Heretofore, the industry has functioned on a basis in which the only thing that anybody gets paid for is executing a transaction. That has become increasingly less satisfactory as it has become, in terms of costs and other things, a smaller component of the entire service package. I would think the regional exchanges and others might devise packages of service for investors and means of paying for them which might provide needed innovation in that area.

SHELTON: I would like to raise a question that links to Mr. Loomis's answer. So much of the discussion in the papers and across the conference table seems to have focused on the issue of the competitive viability of regional exchanges in a world of negotiated commissions, consolidated tapes, and unrestrained third-market activity. It seems as though this discussion assumes there are no externalities to be considered when evaluating the regional stock markets. That is to say, if the regionals can't survive the competition, perhaps they should wither away. I would like to

hear Commissioner Loomis's view on whether he thinks there are any external economies associated with regional exchanges that might make them worth sustaining even if they prove not to be economically viable as "isolated profit centers." In this regard, I am thinking especially of the role that regional exchanges may fill by providing a broader, more liquid, and more visible market for the stocks of small, regional companies. If the regional exchanges die out, will small firms encounter increased difficulty raising equity capital in the future?

LOOMIS: Yes, I touched on that in my remark.

SHELTON: But you did not touch on your answer to it, and that is what I was worried about.

LOOMIS: The reason I did not is that we are talking about a national market system which is designed for securities of national interest. The regionals will, of course, contine to provide markets for regional securities.

GUERIN: I am just curious. You are talking about the elimination of 394 and the elimination of fixed rates. We are now in a negotiated rate environment. Why should exchanges exist at all? Why should anybody belong to an exchange? Isn't it just a natural stamping ground for trading firms and very large processors who then establish some very low wholesale rate for all the other big producers?

LOOMIS: I am not sure I got the whole thrust of the question. You seem to suggest that if fixed rates and 394 go out, the incentives to exchange membership will disappear and various things might follow. Now that, to a degree, is true. That is, the commission rate and 394 have created barriers and enclaves, if I may put it so, for particular brokers and specialists. Under the new regime, I would suppose, customers' orders would flow to market centers offering the best quotations. In effect, it is contemplated that persons would be members of a central market system which would give them access to any market center rather than only to a particular exchange. That is a long way off, however. Initially, membership on exchanges will exist. The Midwest Stock Exchange expressed concern at the hearings Tuesday [November 19, 1974] as to the existing definition of membership in terms of commission rates; how that will work after May 1; and the necessity of getting the definition of member, as the term is used in the 5050 legislation, before that time. I agree with that. I think that the exchange function may become more that of providing a marketplace than providing a satellite system of brokers who are able to go only to that marketplace.

GUERIN: Harvey [Rowen], if the institutional membership question is eliminated when you go to negotiated rates, what is the difference between an institution and Merrill Lynch? Merrill Lynch also is a producer of large quantities of retail orders. Why wouldn't Merrill Lynch just negotiate those orders at a very low rate with a big processor at a trading firm and forget its membership?

ROWEN: I think, John, that people will continue to be exchange members as long as they feel it is either to their advantage, to the customer's advantage, or both for them to do so. It is going to be an economic decision made by the member firm. If the exchange provides some economic service to them by way of providing a good marketplace, by way of providing clearance and settlement capabilities or any other useful services, so that managers of the firms decide it is in their best interest to belong, they will belong; and if they decide that it is not in their interest to do so, then they will not belong. I think Congress has approached this thing as a problem, or an opportunity, to figure out a way or mechanism of allowing public customers to try, and hopefully get, best execution and best service. Just how—whether through the facility of something called an exchange, or a black box, or a combination of the two—we hope will emerge through a competitive process over time. We believe that if the exchanges structure themselves in a way that is attractive to member firms, such firms will continue to belong to them.

LOOMIS: I would like to comment on Professor Mendelson's question on whether the commission is in favor of having orders directed to one exchange or the other by a computer. We have not said that. We have not proposed to take away from brokers the right to send their orders where they please, so long as they do so, consistently, in search of best execution.

FEUERSTEIN: There seems to be in this discussion the implicit assumption that it would not necessarily be a bad thing if fully negotiated rates lead to exchange membership only by those people who are in fact specialists in execution, i.e., dealers and floor brokers, with other members of the securities industry using their services, but not being members of the exchange. Of course, the only thing that is inherent in a central market system is that all the *orders* in fact flow through that system. It is not inherent in the central market system that regulation of the retail activities of the business also take place by exchanges. There is another self-regulatory body in existence in the United States that has jurisdiction over virtually the entire securities industry, without regard to their membership on exchanges, that could perform that function.

SERVETNICK: I would like to ask Mr. Baker if there are to be competing market makers in the central market system? If one particular market maker, because of his capital structure or individual skills in making the market for a particular stock or group of stocks, becomes the dominant market maker or sole market maker in that area, what would be your attitude in the Justice Department of the evolutionary processes that led to this result?

BAKER: The antitrust laws always have recognized that someone who achieves a monopoly position *solely* by skill, foresight, and industry is entitled to retain that monopoly position, so long as he does not indulge in any anticompetitive practices. If this were not the rule, antitrust would be

penalizing success at doing what it seeks to encourage, namely, entrepreneurial initiative and hard work.

WEEDEN: Does Xerox agree with you?

BAKER: I would hope so. But they are in the midst of a Federal Trade Commission monopolization case, and I wouldn't want to comment on the evidence in it.

Going back to the original question, I would find it very different to have a monopoly market maker because he has done a much more efficient job over a period of time than anyone else was able to do—as opposed to having a monopoly market maker because the NYSE or the SEC said "there shall be only one." As long as other potential market makers are legally free to enter and compete with him, the monopolist will not be alone in the field for long if he does not continue to do a superior job. The scale economies and entry barriers are simply not that high for an efficient new entrant who wants to challenge a declining monopolist. The third market experience is helpful here: that institution grew up and prospered because it could do a better job on a net basis than monopoly specialists and exchange brokers often could do under the fixed commission system and various other competitive restraints. In sum, my concern is very definitely with monopoly market making which comes about by legal fiat or private restraint, rather than clearly superior competitive skill in a fully competitive environment.

GLAUBER: I guess I want to ask Don Baker, Do you think this is a type of business that is likely to lead to a monopoly position, or does it have the characteristics that prevent entry?

BAKER: No, I definitely do not. I have simply been making the assumption that it *might* occur in order to answer the prior question. In fact, I do not see any reason why we should expect to have market making done on a monopoly basis, or brokerage either. In fact market making does not seem to be characterized by such pervasive economies of scale as to be subject to anything like "natural monopoly" characteristics. As you know, for over six years now the defenders of fixed brokerage rates have argued loudly that their elimination would lead to "destructive competition" and to a brokerage industry dominated by two or three firms. However, they have entirely failed to make a case as a matter of economic evidence, and I just do not see it happening as a matter of fact. Thus, as long as we have a system of entry based on objective qualifications rather than subjective regulatory or self-regulatory judgments, we seem very likely to have competition both in brokerage and in market making.

WEEDEN: I think where you have the opportunity for someone to develop a monopoly of that sort in other securities, government bonds, or municipal bonds, you have not had a monopoly develop. I think the evidence is that it would not here, either. Now there was that case where the Street, as a monopoly at one time back about ten years ago, decided they would have only one bid for State of California bonds. Some fellow

with a computer came in and broke up that monopoly. Unfortunately, he went out of business shortly thereafter.

BAKER: There is a difference between a monopoly and a cartel.

WEEDEN: My question may sound technical, but it is a fundamental question in terms of the central market system, and it is the issue surrounding NYSE Rule 113. I bring it up here because you have made a fairly definitive statement, in your opinion, about 113 regarding the third market, but have hedged a little bit in terms of its application to regional exchanges. I wondered if you would discuss the reasons for Rule 113, which I am sure everybody knows is a prohibition on specialists being able to deal with insiders, corporate officers, or institutions directly, and act as their broker. Could you discuss the reasons for that rule and why you think 113 should be applied to regional specialists even if the central market system no longer has those characteristics that brought us to it in the first place?

LOOMIS: As I indicated briefly, at least in my remarks, the origin of that type of rule was the Special Study, particularly the American Stock Exchange part of the Special Study. We found that specialists who had handled institutional accounts favored those accounts over the public in various ways. The whole relationship was incestuous and in some instances corrupt; but, of course, it evolved around the monopoly position of the specialists. In the environment we had in 1963, the commission felt strongly that that practice should be put to an end. There was considerable discussion, at the time, whether one should go further and provide that a specialist cannot deal directly with any public investors—i.e., cannot have any customers except other brokers. That was not done for various reasons. Now, of course, the third market, in its most important form, was created specifically to provide investors, particularly institutional investors, with a service they could not get elsewhere. They could not continue in business if 113 were applied to them. As to regional exchange specialists, I specifically left that open because that is a matter that is being considered in various circles at the present time. I did not want to indicate an answer at this point. Personally, I am not so sure that Rule 113 should apply to regional specialists, but I just do not want to take a position on that, now.

LEWIS: This is apropos of Rule 113. Two questions. One: Does 5050 address itself to 113 at all?

LOOMIS: Not to my knowledge. I do not think it has any specific provision about that.

LEWIS: The second question is, What would your views be if a New York specialist firm joined the Pacific Stock Exchange because they liked the stock? As a member of the Pacific, or any regional exchange, would a specialist have the best of all possible worlds? Would he be restricted from dealing directly with institutions by Rule 113?

LOOMIS: Well, if Rule 113 survives, I presume provisions would not be

established by which it could be evaded, if that is what you mean. But as I say, the future of Rule 113 and the central market system just is not settled yet.

GARMAN: I would like to know a little bit more about the composite quotation system. We heard a lot about the implementation steps of the composite tape. Specifically, what is contemplated by the SEC as to what a composite quotation system will be? And second, what is its status?

LOOMIS: I think the course contemplated or outlined (we do not have the details yet worked out) would be a quotations system under which all qualified market makers (and qualifications still are under consideration) would be allowed to enter their quotations. I would suspect that while administrative, governing, and other aspects of it may well differ, the mechanical product might well look very much like NASDAQ, supplemented by various interrogation systems. We have a rule calling for plans to be filed for a composite quotation system, but it is in the planning stage now and is not expected to come into operation until next June. The exact timing is obscure, as others have noted. The New York Stock Exchange has indicated it believes it has a proprietary interest in its quotations. The legislation would clarify that problem. The timing, I do not know. I think the enactment of the legislation will affect the timing.

IRELAND: Mr. Baker, since the antitrust division has been most helpful in rearranging the markets this year, did they have a plan in mind before they started? Did they envision what the market would look like next year?

BAKER: I think you just pulled my leg. I think one of the things about the Antitrust Division is that we are very suspicious about government telling you how to do your thing and how to structure it. So our concern has been more with getting rid of the restrictions that prevent it from being done in other ways. In order to do that constructively, you at least have to be able to go through the intellectual exercise of conceiving somehow that it could be done. I think if you want to carry it that far, yes, we had some concept. But, if you then ask me the next question, Did we have a concept we were sure was the right one? the answer would be no. You should not go charging off down the mountain without any idea of what is at the bottom, I suppose; but I do not think that it is our role either to dictate or to tell the SEC how to dictate, but, more often, tell them how we think they should not dictate.

One of the fundamental differences between the antitrust position and a lot of regulators is that many regulators have, and excluding present company and present commissions, what I call the jampot mentality. That is, they have a lot of people out there with slices of bread and the regulator sits there with his pot of jam. His job is to decide how much jam goes on various people's pieces of bread. It is a somewhat subjective process whose results are represented to be in the public interest. The antitrust

approach is to permit consumers in the market to decide how much jam should go on various people's pieces of bread, and in our view the government's role should be to make sure that it works that way.

McQUOWN: I am stuck back on some words that Mr. Loomis used about the proposition of natural monopolies and statutory monopolies or statutory law or natural law, which seemed perhaps to be the same thing. I am interested in decomposing that assumption in the following way in an effort to determine why regional exchanges exist. The assumption being I think, economies of scale being the classical argument, that in both the law and the economics of monopolies, if you want to exclude a favored position by statute or otherwise, that economies of scale presumably would dictate who ends up performing the functions of exchanging information and transferring securities in the marketplace. Now my question arises out of the following: Apart from the information exchange component, which presumably is akin to Mr. Baker's comment regarding the transportation system—the phone lines are in place or the satellites exist—you have some interfaces that people can tap into either to provide or obtain information. Once the price on that security has been established through the information network, what is left seems to be the settlement process where relative advantage and economies of scale might be argued. But when you decompose the regional exchanges into their relative advantages regarding information or settlement, it seems to me that with whatever communications network we have in place, it is hard for me to conclude that there is, or can be, any relative advantage, any monopoly position, derived from superior access to market information. Thus, when I view a regional exchange in a freer form, from a natural law, and there is no institutional constraint regarding membership, however and whyever it was instituted, I cannot see why anything but the settlement issue is open for discussion regarding regional exchanges.

LOOMIS: In the first place, we may need to think about the type of things we have now and are going to have in the near future. To predict the ultimate outcome is difficult, as there is a little more than just information involved in this process. There is also the process of the market maker who usually makes decisions with respect to the orders that come to him and visualizes the regional exchanges as having a place in that function. As to monopoly, what I was referring to is the fact that, in the past, specialists on the New York Stock Exchange had a practical monopoly of the market-making function for the securities listed on that exchange. In the central market system, that is not the way it will be. There will be no legal arrangement which creates a monopoly of market making in one person; the field will be open to others. I do not think that in the foreseeable future it will all become automatic, with market making being done by computer. I do not say that that could not happen someday, but I probably will not

live to see it. I think there is a function, at least in part, to be performed by the market maker.

PAINTER: Mr. Loomis, isn't it just as possible, however, that since the system of dual specialists on the New York Stock Exchange evolved through the passage of time into a single specialist in a given stock, it might also do so in a central market system. Although there might first be competing specialists, with the regional exchanges and so on competing with New York, might we not once again have the same process take place; and ten years from now see that just one specialist has emerged in IBM on the national market system?

LOOMIS: That is conceivable. However, the special conditions that eroded competition between specialists on the New York Stock Exchange will not necessarily be present in the central market system. In some way, it is very difficult for two people to compete actively when they are sitting side by side someplace and each knows exactly what the other is doing or thinking. What you described might ultimately evolve. I am inclined to think it will not, however.

PAINTER: May I ask, aren't you perhaps concentrating too much on the importance of physical proximity and neglecting the fact that there will be electronic proximity between specialists in the national market system; and in a sense they will be very much, even more so, cheek by jowl even though they are separated by three thousand miles?

LOOMIS: Well, in the NASDAQ system there is electronic proximity but there has not been a gravitation there to only one market maker in securities of any importance. It is only in the ones that nobody is interested in that you get only one market maker.

BAKER: I say as an antitrust lawyer, I draw some distinction between cheek by jowl proximity and electronic proximity. The reason is, if you are all sitting around in a quasi-social environment there are a lot more pressures on you not to compete than if you are selling to a guy you do not even know who is way off at the end of the line.

WEST: I would like to make a quick observation. Isn't it fair to say that the elimination of competition between specialists on the exchange was not the result of a natural process, but in fact resulted from agreement between specialists not to compete with each other?

I would like to ask you the following question. I think I understood your answer to the question posed earlier about the regional exchange. Let me rephrase it though, and ask you the question in a slightly different way. If I understand what you are saying, you could see a need and a role for the market makers on regional exchanges if they are good market makers. What role is there for the exchange separate from its market makers, if any?

LOOMIS: The role of the exchange is to provide a framework within which market makers for the various securities operate. Somebody will

have to "run" the market. They do not seem to run themselves. Some of the things that Don Baker suggested may happen if they do. Then, of course, the government of the central market system has not yet been settled. There will be some rules which will be systemwide and some which will not be systemwide. The local rules probably will be made by local exchanges.

WEEDEN: I view our firm, in a sense, as an exchange where our management, which is similar in some respects to that of an exchange, has allocated responsibility to various people to make markets. We have, in effect, assigned market-making responsibility to eight separate guys. We have a form of compensation and a relationship between management and market makers that is different from that on an exchange. I think that in the open marketplace, an exchange is simply another vehicle for bringing a lot of market makers together, but in a looser form, where each one of them is an individual entrepreneur who has his own capital and makes his own decisions. The exchange does perform certain supervisory, management, or oversight functions, and provides sufficient communications for those people to assist them to attract inquiry from whatever regional or national areas they want to attract it from; but they assign people to stocks just as we do. So if you go to an open market, I do not think it means that everything has to go upstairs. I think that the physical proximity that we have and that the Pacific Stock Exchange has, but in this looser, more independent way, and the operating functions the exchanges provide, will survive if they [the exchanges] have competitive communications, competitive access, and competitive market making.

Now my question.

I do not know how you fit it into a seminar on regional exchanges, but I am sure we all would like to know what the reaction of each of you is to the Supreme Court decision to take up *Gordon* v. *New York Stock Exchange*—from your particular point of view—and what your initial position will be, if that is possible. I would think that all of you would have some kind of answer.

BAKER: *Gordon* v. *New York Stock Exchange* involved a private antitrust suit challenging fixed commission rates. The SEC filed an amicus brief urging the Supreme Court to take it. The New York Stock Exchange, which won below in the Second Circuit, took the unusual step of also urging that the Supreme Court take it; and, of course, the plaintiff did—which might suggest that it was not the Antitrust Division's choicest vehicle.

We have another case raising the same issue called *Thill Securities* v. *New York Stock Exchange* which has been fully tried and is awaiting, for a year and a half now, decision by a district judge in Wisconsin. The issue, in the narrow sense and in *Gordon*, is whether when you have exchange rules (in this case fixing rates) that have been approved by the SEC, or have

been allowed to go on by the SEC, and that are within the SEC's area of responsibility under Section 19 and some other provisions of the statute, those rules are then exempt from antitrust liability. There has been a loud and continuing battle over the proper principles that should be applied there, and the Antitrust Division's view is quite different from the Second Circuit's. The argument is, you want a process of very careful accommodation between the antitrust laws and the securities laws. Basically, what we want is a theme such as that applied by the court in the *Thill* case, namely, when you have an exchange rule that is approved by the SEC or allowed to go ahead, the antitrust court first of all asks whether that rule would normally, if practiced in an unregulated environment, violate the antitrust laws? If the answer is yes, then the next question is, Is it necessary to the exchange scheme of regulation, in the sense that it makes this thing work and that the same goals could not be achieved in a less anticompetitive way? We have always said that the antitrust courts should then ask the SEC what it thinks about that subject. The SEC tends to feel that this reduces it to what I remember Phil Loomis once called an amicus role.

There are some very difficult problems in this area. The Second Circuit pointed out that exchanges have a mandated duty of self-regulation. You do have an issue of the risk involved if they call the wrong shot. Will they be subject to antitrust liability and treble damages? Won't that have a chilling effect on their self-regulatory responsibilities? We have recognized this as an important issue. In a way, there is a special problem because of the magnitude of damages in these private cases: I made no secret of the obvious fact that the Department of Justice's principal interest is in equitable prospective relief and to be sure that the competitive principles operate to the fullest extent possible. The chilling effect on self-regulation is obviously most extreme when you have damages, and treble damages to boot. The department suggested in one of its briefs, in the *Thill* case, that retrospective damages need not follow from a finding of liability. These may be somewhat separate issues.

Anyway, where we are going, it seems to me, is pretty clear. I expect that both the Securities and Exchange Commission and the solicitor general will file briefs in the Supreme Court on this question, although it is possible that the solicitor general will file only one brief. I doubt that the SEC's interest is going to go away from Circuit stage to the full briefing stage; and I doubt the Antitrust Division's interest, after six years, is going to go away either. The last time this issue came up was in a case called *Silver v. New York Stock Exchange*, which is the landmark case on the subject. In that case, the solicitor general filed a brief which had the signatures of neither the general counsel of the SEC nor the assistant attorney general for Antitrust. He was off on what might retrospectively be regarded as a frolic of his own. The briefing schedules are, if I recall correctly, that the

appellate's brief, which is the first brief up, is due the first week of January, and an amicus brief supporting the appellate must be filed at the same time; a supporting amicus brief, supporting the exchange, would be due forty-five days later. It is a very important case, although it conceivably could become moot as a result of 5050.

ROWEN: In our Study of Securities Markets in 1972 we devote one chapter to this question. We start with the *Silver* case and analyze that and its progeny. The subcommittee [House Subcommittee on Commerce and Finance] came to much the same conclusion as the Justice Department—that antitrust laws do play a role. The Senate Securities Subcommittee, under Dave Ratner's leadership, went through the same exercise and came out at the same place. So you have both our subcommittees, plus the chairmen of the Senate Antitrust Subcommittee and the House Judiciary Committee, agreeing. You have Justice and at least certain parts of the Congress on one side, and the SEC and the securities industry on the other side. Obviously we are not going to play any role in the Supreme Court decision at all; but, like any other decision in the Supreme Court, or any court, the Congress is empowered to enact legislation in light of a Court decision, if it feels there is a need for legislation. I am sure we all will be watching that case with a great deal of interest.

LOOMIS: Don [Baker] has explained the problem in quite a dispassionate way. I suspect the briefs will be a little different. It is not our position, and never has been, that the antitrust laws have no part to play in the securities field. They have, and they have often, as in *Silver* itself, had a rather salutary effect; but it is partly a matter of procedure and partly a matter of philosophy. It is our feeling, for example, that all these questions we have been discussing today, and will continue to discuss, are interrelated; that their supervision requires administrative judgments and administrative accommodation of a variety of considerations. We do not feel that the right way to decide this is to have a district court in Wisconsin, or somewhere else, looking solely at the question of whether there was or was not a restraint on competition—making a judgment on a particular aspect of the situation without having before it, or having the authority or perhaps the analytical resources to weigh, the whole picture. The SEC was created to do that in some areas. Don has an intrinsic distrust of an administrative agency's ability to do such things; but these problems are not, in our view, subject to policymaking by decision in one court on a limited record, because they are so interrelated.

BAKER: The thing that is intriguing about this particular case, coming along at this particular moment, of course, is that it does not come in the same way that some of the great antitrust cases involving regulated industries have come into the Department of Justice and the agencies. There have been daggers drawn on some of those occasions. By and large,

we agree with what the agency is doing at the moment. I think the differences of opinion between the commission and the Department of Justice currently have a slightly theoretical quality about them because we each are talking about the long run.

RICKERSHAUSER: First of all, I am going to ask you if you know whether it will be argued and therefore decided by June, or will the schedule push it off another year?

BAKER: It sounds as though it will be argued in April and handed down on the last day of term, which sometimes means a little bit more hurried opinion than ones that are handed down earlier.

RICKERSHAUSER: The other thing I am raising my hand for concerns the regional exchanges and their survival. I really cannot answer questions about the viability of regional exchanges in the abstract. It seems to me that you have to talk about the mechanics of how the central market will work at the time you ask the question. In the system we have now, the retail broker sends his orders to a particular marketplace first, executes there if he is satisfied he is getting the best execution or, if not, goes elsewhere; and this system is distinguished from opening a black box where he can see all the bids and offers and get there immediately. The exchange has functions, other than its trading mechanism, which may offer inducements to a retail broker to try there first; so when bids and offers are just as good in several market centers—which occurs frequently—brokers will try a particular market first for other reasons. Some of those other functions are better clearing, better bookkeeping, etc. While Don Weeden may be an exchange, or his firm may be one, he does not offer those other functions which may enable some of the regionals to compete with him and with the New York Stock Exchange as well. One cannot compete solely on execution because on a stock such as General Motors, everybody's is going to be at the same price for a hundred shares; you are not going to find a big difference.

SMIDT: Somewhat related to that point, a lot of the questions have suggested that exchanges perform several functions. I would suggest, first of all, that not all of these functions are necessarily subject in the same degree to economies of scale. Second, not all economies of scale occur at this level of a firm. In most cities there are areas where you find many restaurants in one location because of external economies of scale, but no particular restaurants are subject to economies of scale internally. I think that there is considerable experience that suggests that there are a lot of external economies of scale with respect to certain kinds of financial functions. Therefore, it occurs to me that an exchange that is concerned with enlarging its market might consider whether it wants to perform some of those functions at a different location than others.

I would like to ask a question, and all this is an introduction to it, to any

or all members of the panel. Are there any regulatory constraints that would prevent an exchange from opening a branch in another city to perform certain of its functions? Let me be more specific. Are there any constraints that would prevent a regional exchange from performing certain of its functions in New York?

RICKERSHAUSER: I do not want them to say no.

LOOMIS: I will not say no then. The statutes do not say. We have had experiences with exchanges in more than one place. The Midwest Stock Exchange has had various facilities around the Midwest. The Pacific Stock Exchange operates in Los Angeles and in San Francisco. At one point the American Stock Exchange, as I recall, was thinking of establishing a branch office on the Pacific coast. There was, in some circles, less than enthusiasm for that idea. I do not think there is any law against it, however.

FEUERSTEIN: There has been a lot of talk about the regional exchanges being able to attract what you might call "first call" on execution by offering superior services to its members that may be more or less related to execution, such as clearance, bookkeeping, etc. I wonder if Don Baker would like to comment on whether, if a regional exchange were able to develop superior services but made it available only to people who execute transactions on those exchanges, whether that would raise any antitrust considerations?

BAKER: Well, I suspect you wouldn't have asked the question if you did not think that it raised an antitrust issue. There is a fundamental concept in antitrust law called the tie-in: this is where a seller of two related products requires the buyer to buy one in order to get the other. The traditional tie-in cases involved use of leased machinery and the supplies used on it (such as shoe manufacturing machinery and shoe materials or salt-dispensing machinery and salt). A tie-in generally is described by the courts as being illegal per se—in other words, illegal without any actual proof of harm to competition in the particular case. However, I should caution you that the tie-in rules are filled with subtle wrinkles. First, it must be clear that two products are involved—and this often can prove quite difficult to show. In the situation we are discussing here—namely, execution, clearance, and selling—there would be a very serious argument that they were in fact all parts of a single product and that the specific terms simply described various aspects of it. If you got past that and said, "Yes, they are separate products," and you had competitors for the tied products alone who were being foreclosed to any meaningful degree, then the antitrust laws probably would apply to the combination prima facie. This then would take you to the type of issue now pending in *Gordon* v. *New York Stock Exchange*, namely, whether the "execution, clearance, and selling" package was somehow exempted from the antitrust laws. Even under our view of the issues in *Gordon*, such a scheme would be legal if it

were necessary to make the Exchange Act work. If what you are about to say is that it isn't necessary to make the scheme of regulation work, but it might be necessary for the survival of regional exchanges, then you have presented an interesting and novel question.

LEWIS: In a real-world execution, whether it is for the public or the institutions, you can add up eight places an institution or an individual can go today to have an order executed: the third market, Boston, Philadelphia, Midwest, New York, the Coast (north and south), or the upstairs market, which would be a position house such as Goldman, Sachs, Salomon, etc. Going back to Commissioner Loomis's opening remark, I think what I was describing is a central marketplace. Isn't the real problem access to those markets, market making, and capital? What does it have to do with monopolies? Those exist right now. The central market has existed to my knowledge since I have been in this end of the business—for the last ten years. I wonder if one of the panelists has any views on that observation. Particularly, isn't it possible that the guts of the matter are access and capital? Obviously, the specialist in Telephone in New York has more capital than the specialist in Telephone in Boston. Because of these facts their competitive positions may be unequal, but they still are competing specialists.

LOOMIS: Yes, access is very important. Broker-dealers traditionally have, more or less, had access only to an exchange of which they were a member. To a degree that still is true. Members of the New York have had such a large proportion of the orders that, naturally, rules which limited their ability to trade in other markets operated to concentrate orders on the New York Exchange. The New York felt that was a very good thing, and in some ways it was. But under the central market system, access will be much more open; and therefore, competing market makers, and particularly competing specialists, hopefully would have better access than they have had before. Most anybody has had access to the third market, but not everybody could use it. I do see a much more open system.

GLAUBER: I would like to return to an issue with which we began: the impact of negotiated rates on the way institutions, particularly mutual funds, pay for research. There is a scenario accepted by a number of people which suggests that institutions will be unable to afford to pay hard dollars for research, and because they will fear lawsuits, will be unwilling to negotiate higher commissions to pay for research. In this environment what may emerge is a few large, fully integrated firms which will give away a research product as part of the execution service and absorb the research cost. Do you think this is a likely outcome, and if you do, is it one worth encouraging?

LOOMIS: We recently held a conference which was visualized, at least by me, as a conference on the relationship between institutions and

brokers in a competitive environment, and what the institutions would expect and receive from brokers. It developed primarily into a discussion of paying up for research. It has been said that no decisions were arrived at at that conference, one reason being that there was no intention to do so. The purpose was to obtain ideas and get broker-dealers and institutions to sit down together instead of in their respective corners, being suspicious of one another. There is the scenario that you described. On the other hand, there also was another scenario advanced that some brokerage firms will specialize in executions and others will specialize in research. The institution will go to a research broker-dealer if it needs research and will pay a little bit more. Other people said that research really is not a tremendously expensive aspect of the brokerage business as it now exists; that the proportion of their expenses devoted to that purpose is not very large; and that consequently most firms that wanted to appeal to institutions would continue to provide research. There was a feeling that the research problems and openings in this field are so broad that no organization can have, in house, a complete research capacity—not even the biggest, let alone the smallest, institution. Brokers who have particularly good research in a particular area of interest, which might be a class of securities, or economic conditions, the Middle East, or what have you, would get business; and the business would be spread among brokers simply because no one broker could do it all. That is the scenario I think we are likely to see.

JENKINS: I would like to refocus the discussion somewhat and ask the panel to evaluate the role and the performance of the industry's own central market advisory committee. This is serving an important function now, and many of the positions we are discussing today apparently will be agreed upon before this committee.

ROWEN: Are you talking about the SEC's committee or the Securities Industry Association (SIA) committee, or both?

JENKINS: I was discussing the SEC's; but if you care to address yourself to the SIA's, I would appreciate that too.

LOOMIS: One reason perhaps that I have been a little reticent, or a little more so than I would care to be, is that I do not want to appear to be pre-empting decisions that the committee will make. That committee is working very hard. I see copies of their agendas which are, as is customary in this business, inches thick; and their problems are difficult. I think it is a very good committee. We hope a lot comes from it. I gather that they do not find themselves in instant agreement on everything. They have a good deal of work to do, but I think that they will be one of the channels through which what I said in my speech will be accomplished; that is, the commission does not dictate these things, preferring to rely on and benefit from industry initiatives.

ROWEN: I think, from our subcommittee's point of view, of course, we look to the commission. We think it is probably a good idea for the commission to get expert advice from people out in the real world, so to speak. The committee has some excellent people on it, some of whom are here today, and I am sure that their deliberations and recommendations to the commission will be useful. The commission, however, then will decide on their own what they want to do, whether they are going to follow those recommendations or not, or modify them and go on from there. Of course, in our oversight capacity we will be looking over the commission's shoulder. I am hoping that this process will move in a good, sound, constructive way.

LOOMIS: When I said pre-empt, I recognize and the commission recognizes, but particularly the Congress *expects* that the commission ultimately will have to make the decisions; but we have appointed a committee to advise us and it would not help the committee if I were to say that they should decide something, in some way, right now.

NEWMAN: We have talked a lot here about restructuring a new central market system, or financial markets, or whatever term you choose to use, through the use of communication devices, machines, and various other applications of technology. There is still another very important factor in the business, however, and that is its people. I am not assuming that self-regulation is infallible or surveillance is infallible, because it has been proven that it is not. But does the SEC envision that they are going to have a role, at some point down the line, in supervising areas that are now self-regulated, either by the NASD or the various exchanges? How well do you think people who are coming on to this system are going to be tested and regulated and various other assorted things done that are necessary in order to have a reasonably well-functioning market system?

LOOMIS: I think it will be gotten by self-regulation. I think self-regulation has a part to play and is essential. It does many things which we just cannot do or do not want to do. The commission's oversight of self-regulation probably will be a little more comprehensive than it has been in the past, because the Congress intends it to be that way; but the functions you describe, testing and qualifying, training, guiding and regulating, to a degree will continue to be performed in the first instance by self-regulation. The exact self-regulatory structure in the future is not 100 percent clear. We will start with the existing structure, the NASD to a degree, but particularly the exchanges. There will be certain rules that will have to be common to the system. There will probably have to be some organization to exercise governance over systemwide problems. How the subsidiary functions of testing, training, evaluating will be allocated among self-regulatory bodies is, I think, essentially a decision for the industry.

BAKER: Can I say one thing? On self-regulation, I think that there is some significant dissatisfaction with self-regulation as applied to what you

might call economic matters, like rates and entries and so forth. I see the long-term trend toward either leaving these questions to free markets or putting them in the hands of the commission and keeping the self-regulatory goal primarily oriented toward such things as health and safety and similar kinds of issues.

ROWEN: Of the two choices, the better in my opinion is the free market, not turning over such matters to the commission. And, I believe, there is growing sentiment among a lot of people in the Congress and in government in that direction.

PAINTER: Question for Harvey Rowen. One of the advantages of regional markets stressed this morning has been their past and potential capacity to develop innovative and competitive systems for clearance and settlement of securities transactions. What effect, if any, do the current legislative proposals have on efforts to eliminate the stock certificate entirely? First, could you give us a summary of the status of the Senate and House proposals to eliminate the certificate. Second, if the certificate is eliminated, wouldn't this advantage to the regional exchanges in developing innovative clearance and settlement systems correspondingly diminish?

ROWEN: Number one, the Senate and the House have virtually identical provisions which call for elimination of the stock certificate as a means of settlement between brokers and dealers by the end of 1976. The longer-range plan was to try using the mutual fund approach. If a person wants an engraved stock certificate and asks for it, he or she may have it; but in the absence of a request, that is, after we get some kind of evidence of ownership, it is not engraved.

The second question. I am not so sure that the regional's role will be diminished. There still has to be some method of getting the money from the buyer to the seller, and the evidence of ownership transferred from the old owner to the new owner. However that is to be done, it could be that the regionals will be able to provide useful facilities for doing it; particularly if you want to let local brokers clear regionally, and not require them all to go to one particular geographic location, even if it is three thousand miles away.

GREENE: Harvey, on a somewhat similar, related matter. You mentioned pre-emption of state laws this morning. I wonder how far H.R. 5050 goes or what is contemplated with respect to other areas of state law; for instance, the registration of broker-dealers and their registered representatives in various states where they do business. If you have a black box physically located in a state, or if you have access to a broker in New York, or by a New York broker to the Pacific Exchange, and so on, does H.R. 5050 or your committee comtemplate any pre-emption of state regulation?

ROWEN: No. There was one specific section in the Senate bill that says it shall not be a violation of securities laws or any other federal or state law for a fiduciary money manager to pay something more than the lowest

available brokerage commission rate. The rest of the bill does not spe… directly to differences in state and federal laws.

GREENE: I think I will also ask Harvey something about the applicabili… of state tax laws depending on where the black box is.

ROWEN: Yes, that is true. There is something about state transfer taxe… depending on where the clearing entities are located.

GREENE: You mean it precludes a state from imposing the tax?

LOOMIS: It precludes a state from taxing solely upon the basis of the fact that a black box is located within its borders.

ROWEN: The black box is a clearing box. It deals with transfer taxes.

GREENE: What does that do to New York City's tax on executions?

CALVIN: Just to help out the panel, it tracks existing New York law. It does not make any substantive change.

ROWEN: There was no thought on the part of either house of Congress to pre-empt state law or to pre-empt blue-sky commissions in their registration of brokers and dealers.

WEST: We have understandably spent a tremendous amount of time this morning talking about very technical kinds of questions. Yet, when Mr. Baker started this morning he began with some fairly philosophical points about the regulator and the relationship between those who regulate and those who are regulated. He talked about the kind of symbiotic relationship he apparently feels has existed over the years and that sometimes has not been in the public interest. I suppose if you read Nader or Friedman you also would come to that conclusion. I would like to ask a political science question. Here we have the SEC, congressional subcommittees, and the Justice Department moving fairly vigorously, all at the same time, in a way that from my perspective appears to be at least antithetical to the largest vested interest in the industry. How did that happen? How could we get the same result in trucking?

ROWEN: It would take, I suppose, an afternoon to discuss this. I think there is a convergence of various things—events, human beings, and institutions—all of which have led us to where we are. How you apply this to other areas . . . ? I would not know where to begin. I have no answer to that right now.

LOOMIS: I think that because of the nature of the SEC's role at the start, which has not been one of economic regulation, and referring to Don Baker's remarks about the jampot, one of your chairmen said, about 1958, that all the SEC has to pass out is trouble. As a result of that, there has been a somewhat different relationship, although we do have to be sympathetic with the essential problems of the industry and its institutions. Sometimes we have said, unfortunately perhaps for our freedom of action, that this is an essential industry.