This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Explorations in Economic Research, Volume 2, number 3 (Regional Stock Exchanges in a Central Market System)

Volume Author/Editor: NBER

Volume Publisher: NBER

Volume URL: http://www.nber.org/books/conf75-1

Publication Date: 1975

Chapter Title: Views from Regional Exchanges

Chapter Author: Elkins Wetherill, G. Robert Ackerman, James F. Dowd

Chapter URL: http://www.nber.org/chapters/c9227

Chapter pages in book: (p. 390 - 411)

Views from Regional Exchanges

Panelists: ELKINS WETHERILL, G. ROBERT ACKERMAN, JAMES E. DOWD

ELKINS WETHERILL: In May 1965, Mr. Wetherill became the first full-time president of the PBW Stock Exchange. He is past chairman of the Pennsylvania Securities Commission and practices law in a firm he helped found, Henderson, Wetherill, O'Hey & Horsey, in Norristown, Pennsylvania. Mr. Wetherill is a graduate of the University of Pennsylvania and of its law school.
G. ROBERT ACKERMAN: Mr. Ackerman is president of the Pacific Stock Exchange, an appointment which he received in May 1974. Prior to joining the Pacific Exchange in 1973, he was associated with Goodbody & Company, where he was a general partner and served as a member of the firm's executive committee. Mr. Ackerman is a graduate of Hamilton College.
JAMES E. DOWD: Mr. Dowd was elected president of the Boston Stock Exchange in July 1969. He joined the staff of the Securities and Exchange Commission in 1951 as a trial attorney, and received appointments as chief enforcement attorney, assistant regional administrator, and New England regional administrator. He is a graduate of Boston College and of the Boston College Law School.

WETHERILL: Do the regional exchanges have a role to play in the long term? Even if they have such a role, can they survive the short term and thus have the opportunity to play that long-term role?

I would answer yes to both those questions. But saying yes does not make it happen. There are so many unknowns in this formula that it reminds me of the comedy routine that those two comedians, Bob and Ray, used to put on. One would say to the other, "I haven't seen you for a long time. How've you been?" "Gosh, I've been fine. What are you doing now?" "Well, I've got a new job." "What's that?" "I'm a radio announcer." "Gee, that's great. What do you announce?" "Oh, I ad lib stock market quotations." So, perhaps that is what I am doing. The original exchanges have survived for many years. The PBW has survived since 1790, the oldest exchange in the country. They have survived and played varying roles over this long period of time. First as very regional exchanges, trading only regional stocks among regional brokers for regional customers; then moving into dual listing, trading mostly for regional-only members; then expanding into dual listings for dual members; and moving on, as you all recall, into the late 1960s when they became to many a conduit for all kinds of reciprocal business. In addition to their role as market makers, they actually spent much of their time funneling New York Stock Exchange commissions, here and there.

Moving then to today's climate, I think we find them stronger than ever. They are making contributions in areas of innovation, competition, and regulation. In terms of innovation, they have moved forward in such areas as foreign members, institutional members, and in providing alternate specialists. We have opened a floor in Miami, a new experiment. We are moving toward trading of options and trading of government securities. We have brought institutional specialists to the floor. Two life insurance companies are running books on our floor, which is certainly an innovative move. It has brought needed capital to the floor, and we hope to try to expand that before we are told that institutions cannot continue as members. We developed our own system, which we call CENTRAMART, which is a computer system that operates on our floor, into which specialists can input their trades and their quotes. This will help us to tie in not only to the combined tape, but also to the quote system when it is developed.

The regional exchanges are very much alive and making real contributions in the areas of innovation, competition, and regulation. We have just discussed some areas of innovation.

In competition, I think there is no question but that the regional markets are stronger, that they actually are competing in the market-making function better than they ever have. They also are competing, as we discussed in the last panel, in the area of services such as clearing, and in many other services that are being offered to members.

In regulation, I think the professional staffs the regionals have developed over the past ten years have provided a much needed link in the field of regulation, especially in the self-regulatory area.

With all of this, why shouldn't the regional exchanges continue to survive? I think they will. I really do think they will continue to survive, but there are great changes about to take place, as you all know, and that is what we are here to talk about. Some of these changes are going to have severe effects on the regional exchanges in the short term, and perhaps severe effects on all the exchanges. There are those who question whether, in the short term, with fully negotiated rates, the exchange system, let alone the regional exchanges, can survive. The short term is going to be difficult.

What do we mean by the short term? To me, the short term presupposes, first of all, the composite tape, fully negotiated rates, either the adoption of Rule 19b-2 or legislation that will bar our institutional members from operating as they do now. This then will be a most difficult period for the PBW; perhaps less so for some of the other regionals who are not faced with the loss of forty institutional members who were providing almost 50 percent of our volume. Since the institutions have been trading less, that has gone down to somewhere in the area of between 25 and 30 percent of our volume. Still, when we lose that volume, it will be a severe blow to our exchange. Also, I see the difficulty here, with fully negotiated rates, of there being less incentive for exchange membership. With dealer markets probably being made in many firms' offices and trades not coming to the floor, there will perhaps not only be a decline in exchange membership, but certainly a decline in the order flow brought to the exchanges. Also, when we move to a composite tape and have not yet reached composite quotes, it will be extremely difficult for the regional specialist to operate. He will not have access to a system. Although his last sale will be known, I still feel that it will be very difficult for him to operate in that environment.

Another detriment to the continuation of the regionals during this near-term period will be the lack of reciprocal business. With fully negotiated rates reciprocal business probably will dry up; this has always been a great source of volume for the regional exchanges. All these things are going to be tough to handle, but I think we will survive them because we think we will be able to fill in the gaps with innovative moves. We are planning to move into the area of options where, I would say, we are well on our way to satisfying the SEC. Our financing package, how we propose to finance the program, has been filed with the commission. Our rules have been approved by the staff of the commission. We have worked out an arrangement with the Chicago Board Options Exchange (CBOE) and Amex to join the National Clearing Facility and become a one-third owner. We hope that everything goes as planned. By the end of January, we should be trading options in a few stocks on the floor of the PBW. This will help to fill the gap.

Our Miami operation is growing daily. There is a tremendous amount of retail business, as you know, in the Miami area. Miami itself is a parochial sort of a place. They love their football team and various things that are dear to the hearts of all Miamians. There seems to be a real interest in doing business with a Miami-based facility. We are getting a good deal of interest from the local banks. Of course, they are not the size of New York, Chicago, Philadelphia, and Los Angeles banks, but their trust departments are beginning to grow as people retire, move to Florida, and move their trust accounts with them. These banks are directing brokers to place their orders on the local floor. This is another area where we hope to fill the short-term gap.

In a month or so, we are going to begin trading in odd lots of government securities. This will be another new move for us, in which we hope some interest will develop.

We are working with the other regional exchanges to develop what we have called a mini consolidated quotation system, whereby we will link together the floors of the regional exchanges, and specialists will be able to know each other's quotes and trade and lay off on each other's books. This, I think, may have been mentioned yesterday. We are, as I said earlier, working to bring institutional capital to the floor of the exchange. We have always felt that if the institutions, with their large orders, are partially responsible for the illiquidity of the marketplace, then one of the ways to solve that illiquidity would be to force the institutions to commit a portion of their capital to the market-making function. This was one of our goals when we first considered bringing the institutions in as full members of the exchange. It took us a long time, of course, because of the conflict of interest and other problems the institutions faced before they could take this step. But two of them have done it, and another one now is considering doing so. It is just unfortunate that it happened during the summer that the market performed so badly; the institutions simply did not want to trade much. So we haven't seen, as yet, the full potential of this experiment. But the money is there and, I think, the trading expertise is there. All we need is to see a flow of orders for the experiment to become full-blown.

These then, are some of the things I think will enable the regional exchanges, especially the PBW, to survive this very difficult short-term period, the period between the adoption of the composite tape and fully negotiated rates and the adoption of the central market system.

I think once we reach the long term, it will be much easier for the regionals to survive. The long term presupposes consolidated quotes and the composite tape already in existence, moving into the national clearing system, and finally moving into the central market system. In that system, regional specialists will be able to compete. Not all regional specialists will be strong enough to compete; not all will have the expertise, nor will they have the capital. But I think there will be those who are able to compete and who, during the course of the trading day, will from time to time be making the best market. If it is the fiduciary obligation of any broker with an agency order to find the best market, he will be forced during the trading day to go to the regional specialists; not always, but as their markets are the best. I think that the regionals will survive, and the whole exchange system will be stronger once we reach that point.

One of the things I would like to suggest to Mr. Loomis and Congressman Moss is something we have mentioned before. That would be for the Securities and Exchange Commission to reverse its priorities. It seems to me to be an easier way to bridge this gap between the difficult short-term period and what seems to be the easier area of fulfillment. They have been advocating, for some time, two major goals: fully negotiated rates and a central market system. One ties in with the other. If we could persuade the good commissioners to reverse their priorities and work toward the adoption of the central market system before they go to fully negotiated rates, it would bridge this gap. Both goals still would be accomplished. If the industry could persuade the commission—and we hope to try to do this during the hearings now in progress—that both goals will be adopted and that the industry will work hard to move to the central market system, if the commission will only put off the day of fully negotiated rates at least until the quotes have been adopted, regional specialists will then have access to the whole system, and the transitional period will be far more orderly and constructive.

ACKERMAN: As I stand here this morning, I can't help but recall some of the remarks Mr. Rickershauser made yesterday. You may remember that he classified our audience into two basic parts: one being those of us involved in the so-called real world (that is, those who are engaged in brokerage firm operations, market making, and exposing their capital on a daily basis), the other being those who are primarily lawyers, academicians, and representatives of the government. Since I do not happen to fall into either of those categories, I am not sure I should be here at all today. And having listened very attentively yesterday to some of the prognostications concerning the future of regionals, the thought occurred to me, as I am sure it has to some of you, that perhaps we on this panel might better spend our time concentrating on job résumés.

Please do not misconstrue this as an attempt at humor on my part. Jim Needham, the chairman of the NYSE (credit to Professor Ratner) expressed at a meeting I attended in San Francisco a couple of weeks ago that this is no time for the head of any stock exchange to try to be funny. So I'll try not to be.

I do not happpen to subscribe at all to the theory that the current restructuring of our industry is sounding the death knell for regional exchanges. On the contrary, I feel that the future has never been brighter.

Certainly, we have some adjustments to make and, of course, we will have to come up with new ways to compete. But we have been doing this for a long time; we are used to competition; and it seems to me that those who know how to compete have a distinct advantage over those who in the past have never really had to compete. We at the Pacific Stock Exchange heartily endorse the central market system because it promises to give us an opportunty to compete on an equal basis, and believe me, that is a real plus.

Recently at the Pacific, we completed an analysis of the probable effects on our volume of the emerging central market system. I would like to share some of those results with you. To begin with, we divided the central market system into four basic elements: the composite tape, the composite quotation system, the clearing and depository interfaces combined, and negotiated rates. For the purposes of this analysis, we have considered it in two lights: first, the effect on trading activity in terms of the number of trades and, second, the financial impact each would have on the exchange overall. We are hoping that the composite tape will be expanded from its pilot form to include all securities, and that the February twenty-first date for beginning full operation will be met. We think this is critical. I must explain that we have taken some broad-band ranges in these figures. We first considered the most pessimistic possibilities and their ultimate effect on Pacific. We also have considered an optimistic view, and we then tried to arrive at a midrange, most likely possibility.

In the composite tape area, we look for an increase in the number of trades per month in dually traded securities at the Pacific of somewhere in the neighborhood of 27,000—or a 55 percent increase in the number of executions. The financial effect of this would be an increase in monthly operating income of some $60,000. There are, of course, some increased expenditures involved with the composite tape. We have cranked those figures into our net operating accounts. The second and perhaps more important element of the central market system, at least to us, is a composite quotation system. We feel this to be absolutely vital. We believe that its effect on the Pacific, and on other regionals, will be far more beneficial than the composite tape. We are striving to recapture trades that now are off-boarded, and expect to increase volume by 30 percent due to the order flow stemming from the best bid or offer that is displayed on a composite quotation system. We must remember, of course, that there are two sides to every transaction; there is a buyer as well as a seller. If you assume, for example, that the New York market is 41½–⅞ and the PSE market in that same dually traded issue is 41⅜–¾, obviously New York would have the best bid, but Pacific would have the best offer. We would hope to attract one side of that trade, which would be a 100 percent increase over what we are seeing today, because of the historical monopoly that exists in the East, and because of the communications systems that some brokers have which direct all of their trading to the eastern exchanges.

The third element, which also is positive as far as the Pacific is concerned, is the clearing and depository interface. As you know, many of these interfaces are presently underway in pilot form. I would like to take a moment to talk about the interface Pacific has with the National Clearing Corporation. This got underway about six weeks ago and is being expanded to handle OTC trades for all NCC members. At the moment, this is the only true national clearing interface in the country. Members of the Pacific Exchange can clear and settle both listed and unlisted transactions through one clearing corporation and obtain one net sheet. Professor Mendelson has raised the question of whether brokers who are handling both listed and unlisted trades always will have to deal with two clearing entities as long as NCC exists. I can assure you that that is not the case, as the interface that Pacific has through its clearing corporation for over-the-counter trades makes apparent. It would seem to me that the same sort of arrangement ought to be followed with other clearing corporations. This interface is operating very, very well, and has proved to be a classic example of what an interface should look like and what it can mean to the members who make use of it. A clearing interface for listed securities presently is operating on a very limited pilot basis with the Securities Industry Automation Corporation (SIAC). We expect to expand this within the next couple of weeks, and look for a very positive effect there. We do not see that there will be any additional clearing expense to wire houses, and as a result, we expect additional PSE trades. There also will be less incentive for our dual members to split orders. I think you all are aware of what that means. When an order comes to the Pacific floor, say a thousand shares, our specialist may take only a portion of it; the balance then will be shipped to New York. It may be executed at the same price, in most cases it probably is. The customer is not affected, but the brokerage firm ends up having to process two clearing items instead of one, thereby increasing its expenses. The interface of clearing corporations will do away with that, and we expect regional exchanges will be shown more orders as a result.

We have talked about depositories. As you know, Pacific recently received trust company status for its depository, and is proceeding as quickly as possible for full interface with both the Midwest and New York depositories. When that system is completed, brokers in New York will no longer be exposed to additional charges for shipping stock to the coast, since this can be done through bookkeeping entries. We feel that this will increase trading on the Pacific and on other regionals that are involved in the interface. We expect this will translate into 5,000 trades per month, for an estimated 10 percent increase in the number of executions. The dollar impact from the depository interface should represent an additional $21,000 per month in net operating income.

The fourth element of the central market system is negotiated rates. This is the one area that we see as detrimental to regional exchanges, including the Pacific. It is detrimental because we expect a loss of business due to the reciprocal aspect that Elkins Wetherill touched on a few minutes ago, and we see a reduction in the number of firms doing brokerage business. We estimate the negative effect as being a loss of 80 percent of the reciprocal business we currently receive, plus business lost from brokerage firms that may disappear. From this, we look for a decrease of 9,000 trades per month. The financial effect of negotiated rates, and this again is midrange, comes to something like −$20,000 per month.

So it is important to us that before proceeding with negotiated rates, we make sure that the other elements of the central market system are in place and operating. These other elements all are beneficial to us; but in their absence and with the advent of negotiated rates, there is no question but that the regional exchanges could experience some difficulty. Once all four elements are in place, the net effect should be beneficial for regional exchanges. We estimate a 62 percent increase in the number of trades and a total positive financial effect of approximately $35,000 per month. We have not cranked into any of these estimates such factors as fiduciary requirements by brokers to seek the best market. We have not considered the effect of a class action suit by a public investor who was forced to pay an unnecessary tax because of the marketplace his broker designated. I think such a suit is inevitable. I think when that comes, the public investor will make certain that his broker does not expose his sell order to a marketplace that requires payment of a tax, but will insist that his order go to an exchange outside of New York. Also, we have not taken into account what effects entry into the options business by the Pacific Exchange will have. We fully intend to enter the options business, and are proceeding rapidly to prepare a plan for submission to the SEC sometime next year.

The real world today recognizes that maketplaces are chosen by brokerage firms primarily on the basis of their own economics, and not on that of the public customer. I think brokers should check *all* markets to obtain and consider factors such as the tax consequences to their customers. We see this practice changing under a central market system, and we see the resulting redistribution of order flow having a positive effect for the Pacific Stock Exchange.

DOWD: We in Boston obviously have not anticipated with great glee the impact of fully negotiated rates in advance of a central market system. I can confess candidly that, if we had our druthers, we would much rather have the central market system in place before fully negotiated rates are adopted. The reasons, I think, are clear. As both Elkins and Bob indicated, we feel that fully unfixed rates will have a negative impact on incentives for regional exchange membership. If a sole member can negotiate a satisfactory rate to have all of his business done in New York, does he really need a regional membership? I hope that Congressman Moss and Phil Loomis, as part of my captive audience, will bear in mind that the imposition of fully negotiated rates, before at least the key elements of the central market system are in place, could have severe results on the regionals, and particularly on their membership.

As indicated yesterday, the regionals have been innovative in many areas. and it is hoped that they will continue to be innovators. If they do come up with innovative packages for members and investors, they certainly have a right to a place in tomorrow's sunrise. You have heard from Dave Rubin, from Dave Heller, from Barry Tague, from Elkins Wetherill, and Bob Ackerman, and can conclude that the regionals have not been rolled over dead for the past ten years. Indeed, most of the innovations in this industry have been developed, massaged, and either discarded or adopted initially by the regionals. In automated clearing, in communications, in custodianship, the regionals have been the pioneers. In a word, we intend to survive the advent of fully competitive rates in a central market system. Collectively, we look forward to unfixed rates with great anticipation, provided that the key elements are in place at the proper time.

What have we been doing in Boston in anticipation of these impacts? As Dave Rubin indicated this morning, we have almost completed our conversion toward the continuous net settlement system. We have been clearing OTC securities very successfully for the past eighteen months. We have applied to the Massachusetts legislature for authority to have the bank commissioner issue us a limited purpose trust company charter for the purpose of establishing a depository in New England. There is no doubt that political problems have prevented our obtaining a full-purpose trust depository. The simple fact was that the major banks in Boston could not agree among themselves as to who the depository would be. Therefore we, the innocent, had to pick up the ball and run to the legislature to seek our own limited purpose trust charter. Since we have been a neutral party, we have been able to get at least a position of no opposition from the major banks in Boston. I think with the advent of the new legislative session, in January, it will not be too long before we will have our limited purpose charter. All of you heard this morning how important the clearing and depository system is to the national systems of tomorrow, and we certainly are going to be a part of that system.

We are in the midst of a major renovation and enlargement of our floor. And you may say, Why would an exchange in its right mind be spending a quarter of a million dollars, in these days, enlarging its floor? Maybe I will regret the impetus I have given to this. However, the fact is that for the past three years we just could not add any more people to our floor. By January 1, we will have room for nineteen new businessmen on our floor—one indication that we are optimistic about the future.

One year ago we organized a back-office service company similar to Midwest's and to that on the Pacific Coast. We anticipated that this would operate in the red for the first eighteen months. We were pleasantly surprised when in August we broke into the black, not even a year into operation. This has been a very successful venture.

As all of you probably know, we are one of the exchanges that accepts foreigners into membership. This dates back to 1969 when we accepted a subsidiary of the second largest bank in Germany. We are not entirely unselfish in this posture. It has been good for our membership, it has been good for the exchange, and it certainly has been good for the New England region. When these foreign banks come to Boston, they bring with them very substantial deposits. It also helps to broaden the shareholder base of U.S. issuers. The foreign members' customers are big buyers, and the fact is that when they buy, they rarely sell.

This leads into another innovative system that we in Boston have undertaken. We are the only exchange, so far as I know, that offers custodianship service. This is a logical outgrowth of foreign membership. It makes no sense for foreigners to buy securities and have them shipped overseas. The building that we occupy was formerly the home office of the State Street Bank, and has a beautiful, big, Class A vault. It made good sense for us to develop, at the Dresden Bank's request, a complete custodianship package. At the last audit, we were sitting on nearly $2 billion of U.S. securities for sixteen foreign accounts. We are not in competition with the banks because we are not bankers; we do not require deposits. Those deposits are sitting in New England banks. We are performing a required, necessary, and obviously very efficient service as custodian for foreign accounts. This grows year by year, and I can tell you that it has been a very good adjunct to our overall service package.

We look on the advent of the common tape and the quotes with mixed emotions. Obviously, it is not without *some* fear and trepidation. Barry Tague and Elkins Wetherill referred briefly this morning to a mini central mart where we, Midwest, Pacific, and Philadelphia are considering the exchange of specialists' quotes among ourselves, so that orders that could not be completed, for example on the Pacific, might be tried in Philadelphia, in Boston, or the Midwest. I am not saying there isn't any competitive aspect in our thinking on this, but it seems to me that if friends in the regionals can't help each other, who can? And the business that will flow to each other, the superfluous business that cannot be done on the Pacific, the Philadelphia, or the Midwest, can flow to one of the others of us. I think we all will benefit from it.

OPEN DISCUSSION

Other participants, in order of initial comment:

Donald M. Feuerstein
Salomon Brothers
Philip A. Loomis Jr.
Securities and Exchange Commission
Robert R. Glauber
Harvard University
Jay H. Mintz
Mitchum, Jones & Templeton, Inc.
Michael Gross
Bunker Ramo Corporation
Donald E. Weeden
Weeden and Company, Inc.
Thomas J. Lewis
Josepthal and Company, Inc.
John A. McQuown
Independent financial consultant
Jon Lovelace Jr.
Capital Research & Management Company, Inc.
Charles E. Rickershauser Jr.
Munger, Tolles, Hills & Rickershauser
William H. Painter
University of Illinois
William D. Ireland
Bank of America
Clemens T. Leuker
Bateman, Eichler, Hill & Richards

FEUERSTEIN: Yesterday, we had some discussion that the experience in this industry has been that reform seems to come only from chaos, crisis, and catastrophe. I wonder, since the regional exchange presidents are suggesting that we should create the central market systems before we have negotiated rates, if you would comment on (a) what form you think the composite quotation system would take; (b) what kind of cooperation you could expect from the New York Stock Exchange in implementing it; and (c) how long you think it would take.

DOWD: Boston, Philadelphia, Midwest, and Pacific, with or without New York, are considering going forward with an exchange of quotations. We think it is very important that we do this. As you know, for years the specialists on the regionals have been operating almost in a blind with only the New York tape to show last-sale prices, but even NYSE members who are regional specialists on the Pacific floor or on Philadelphia's floor cannot receive directly the needed NYSE quotations on their floors. So we do think it is very important that we give each other our quotes as soon as possible. I do not anticipate that New York will jump at the opportunity of swapping quotes with us. Maybe there will be a change in New York's outlook on its "proprietary" rights to its quotations. Maybe there will be a change in their planned opposition to Rule 17a-14. I hope so, because I do think it is necessary.

ACKERMAN: I have also noticed, in recent conversations with Jim Needham, a certain flexibility in his thinking on that. At last report, he was prepared to go to his board with a suggestion that they rethink the question as to proprietary rights on quotes and their willingness to share these with other markets.

LOOMIS: I want primarily to report, for purposes of discussion, a statement on this topic that I heard on Tuesday when the Midwest Stock Exchange was in for our hearings. They indicated they were basically in favor of competitive rates, but like the other regional exchanges, they have some doubts as to its timing. But they did not say that the central market system had to be in place before we went to competitive rates. They simply said that the legislation now pending in Congress should pass before we go on with competitive rates, and that they could go fairly soon after that occurred. They were concerned about the condition of the economy, but did not think that was controlling on the decision. This is another rather statesmanlike viewpoint on this question, primarily because it is contemplated that when the central market system becomes operational there will not be fixed rates. Looking at all the plans, it seems to be the central feature, so it may be difficult to get the central market system in place and operating under a fixed rate regime. I am not quite sure how that can be done. But I agree with the Midwest people that prompt enactment of this legislation would be enormously helpful.

GLAUBER: I would like to ask the panel to explore some of the implications of the impact of negotiated rates on the number of securities exchange member firms. Mr. Ackerman suggested that there is likely to be a decline in the number of members under negotiated rates. It has often been argued that the really important impact of this decline will not be on the character of the secondary market for securities, but rather on the primary market, that is, on the ability of corporations to sell securities and raise new capital. I take it that in your support of competitive rates you have given some consideration to this argument and have concluded that it does not carry enough weight for you to take a position against such rates.

ACKERMAN: I feel that the Securities and Exchange Commission has not fully developed its position on negotiated rates, and we feel this is an area in which there still are too many unknowns. We have not come out in full support of, nor have we come out in opposition to, negotiated rates. The fact is, we have not taken a position, and are not prepared to do so at this moment—and probably will not be for some period of time. One fact we think is determinable is that it will lead to considerable attrition in our industry. I do not know whether that is going to mean the larger firms, the medium-sized, or the smaller firms. I do not think there is any question, however, but that there will be some attrition.

We also are extremely concerned with a subject that has been discussed, which I find of interest. We have not talked about the problems that are inherent in the processing of transactions within a negotiated rate environment. If we have as many different rates as we have different brokerage firms, and take yet another step and figure that there are as many different rates within a firm as there are different types of transactions, I am not sure that the industry is prepared physically to handle the processing of that business. The computer programming that would be involved is considerable, assuming for example that you had a hundred different rate structures within one firm because it does a hundred different types of business. It involves, obviously, very, very substantial computer programming. Having had some experience in Goodbody and Company with what happens when you go overboard in computer programming, I have had good reason to be very wary of this problem. I am not sure that that is an answer to your question. I guess what you are asking is, If the regionals are going to suffer attrition because of negotiated rates, will that not also affect the New York Stock Exchange? And my answer to that is, Yes, it would.

GLAUBER: Excuse me, when I said primary market I did not mean to distinguish between the New York Stock Exchange and the regional exchanges, but rather between the market for existing securities and the market for newly issued securities, by which corporations raise new capital.

ACKERMAN: It would seem logical to me, if you are going to have some reduction in the number of firms doing business, presumably that would mean a reduction in the ability to raise additional capital, because you are not going to have the same number of people pounding on as many doors. That is what it is all about.

MINTZ: I would like to ask two questions. First, to Bob Ackerman and to

Jim Dowd: Do each of your exchanges have plans for initiating option trading? If so, where are you in your plans? Second, and this is for anybody: Does anybody anticipate that the increasing volume in option trading might have an adverse impact on the ability of companies to raise new equity capital?

DOWD: Boston does not, at present, plan to trade options. Maybe it is our old, conservative, puritanic heritage; we look at the game going on but are glad that it is in Chicago's rather than our backyard. I think that option trading has a place for its type of investor. I am delighted that the capability is available to those who choose to avail themselves of it. I am just as delighted, however, that it is not in my backyard, that I do not have to worry about it.

Could I come back and add one additional point by way of an answer to Bob Glauber's question? We understand and are concerned about the possible demise of the regional firm. We are convinced that in some areas regional firms, as opposed to the national wire houses, are prepared for the future. They have in the past and presumably will continue in the future to wait until the farmer is finished milking or plowing to talk to him, or will wait until Saturday morning to talk to him. Certain regional firms will continue to get the business they have enjoyed for years, regardless of negotiated rates. But I will not be overly optimistic and conclude that this will answer all our problems. We look for some membership shrinkage among regional firms. Once they are able to negotiate attractive packages for all services with a New York correspondent, they will no longer need, and have little or no economic incentive to maintain, a regional membership.

GROSS: This is a question relative to the consideration of making the quotes available among the regionals. Would the regionals, prior to proposed enactment of Rule 17a-14, make those quotes available to broker-dealers; and in either case, might NASDAQ be a suitable vehicle for that purpose?

DOWD: It might be a second stage. I think as soon as possible the quotes of dealers on various floors should be made available to each other, at least, I would hope, to the trading desks of the major users of the exchanges. But I do not think you need to have a nationwide distribution of Boston, Philadelphia, Midwest, and Pacific quotes to every trading desk in the country to get this thing off the ground. I think it is a worthwhile second step and a very necessary one, however.

ACKERMAN: I agree with that.

WEEDEN: I would like to go back to Bob Glauber's question about primary markets and secondary markets, and try to pop a balloon which has been raised so long and is full of hogwash; that is, the primary market is dependent upon a particular type of secondary market. I think we should understand that the main primary market is in bonds and over-the-counter stocks, for both of which the secondary market always has been over the counter. That market is going to survive if compensation to the Street is sufficient to attract the efforts of the salesmen, and their merchandise is something that is particularly interesting to the buying public. I think we have found that despite the over-the-counter organization of the secondary market in bonds, the bond market has become a very, very attractive area of public investment and has become a most lucrative area for the industry. I think if anything threatens the exchange, it is that they have a commission rate structure that makes the sale of stock in the secondary market less attractive to merchandise than a sale of the same stock when it comes out as a new issue. If we are going to go down the road of more and more new issues, like Southern Company or Virginia Electric, the efforts of the industry are going to be toward concentrating on the opportunities in the primary market. I do not see any relation whatever between the primary market and the manner in which the secondary market is organized.

GLAUBER: Isn't it true that many of the brokers who distributed, for example, the Southern Company's recent issue, derive a considerable amount of their revenues from transactions in the secondary market on organized exchanges? It is probably misleading to say that most of the securities distributed are traded initially in the over-the-counter market and, therefore, that the type of primary market or the type of secondary market doesn't have very much to do with it.

WEEDEN: Southern Company and Virginia Electric: we inquired as to over-the-counter market profit opportunities for such securities, and that is what the complaint of the exchanges is, that the profit opportunities in the Street will be even greater if you have an opportunity either to make dealer spreads or to charge whatever commission you thought would be appropriate for that merchandise.

FEUERSTEIN: I am usually a calm fellow, but this is the one area in this whole debate that makes me angry. It makes me angry when this issue is raised for two reasons:

First, whether we like it or not—and there are reasons not to like it—the flow of savings in this country is institutionalized to a considerable extent. It reaches securities markets in large part through institutions, not directly from individuals. To think that you can finance American industry by selling new issues primarily to individuals, when it is primarily the institutions that are getting the money, to me is nonsense. Moreover, it does not take the present size of sales force to sell new issues to financial institutions. It is true that you can have important social debates about whether it is good or bad to have financial institutions become more powerful. But unless there are substantial changes in tax and other laws that cause the funds to flow to these institutions, it is and will be a continuing fact of life.

Second, and the point that particularly makes me angry about this issue, is the real economic value of the system that we now are supposedly jeopardizing. It is true that in the 1960s the securities industry constructed a magnificient mechanism for raising capital from the public. But I think we have to step back for a second and ask ourselves: For what kind of business did we raise equity capital? I do not think it is an accident that today the basic core of all industrialized societies, our utilities, our transportation system, our heavy industries, all are either in serious financial and capital difficulties or on the verge of bankruptcy. I think it may be that the mechanism we constructed in the 1960s, which we look upon as the golden age of the securities industry, in fact, misallocated capital from areas of importance to those that are peripheral to an industrialized economy. This capital-raising mechanism may have come close to being the destruction of our economy rather than something very important.

LEWIS: I would like to return to the poor old regional stock exchanges. There has been in the past an excuse used by major wire houses to explain why they do not use the regionals. I can speak with experience on the Pacific Coast. Their execution setup funnels orders from many branch offices, through their computers, directly to New York. This is justified on the basis of cost and efficiency, particularly in a busy market. With that background, we go to the composite tapes, and more importantly we anticipate some day a composite quote system. What response will the wire houses give now, and I am thinking mainly of retail orders, when the best bid is showing on one of the regionals. There is a money factor, and I would assume they are going to have to change their software. If they do not search out the best bid and offer, would there be any pressure put on them by the regulatory body to do so?

ACKERMAN: I think the point you are raising is a very good one, and it is one that we have considered in quite some depth. It has to do with the public customer's becoming more knowledgeable because of the additional visibility provided by the composite tape and quotation systems. I think he is going to become more active in directing the brokerage firm as to where he wants his order put. This has not been the case to date—a fact to which I can attest, having been on the other side of that coin, as a partner in a New York–headquartered, eastern-dominated brokerage firm, with partners who were members on the New York floor. I can recall on several occasions hearing it argued, quite successfully, that we always wanted to direct our orders to the eastern floors because the regional exchanges were not well enough capitalized and the execution might not be as good as it would be in the East. Quite frankly, I believed that and followed the policy in the branch offices with which I was involved for quite some time. I see now, because of the exposure I have had to regional exchanges, that this has not necessarily been the case. Certainly, there have been instances where one market might be better than others, but I think that the executions you can obtain on regional exchanges—I am not talking about orders in size, I am talking about small trades—will be almost identical to, in many cases somewhat better than, what is available on the primary markets.

DOWD: I recall a year ago last July when trading in Occidental Petroleum was suspended on the NYSE because of an influx of orders. The large national wire houses that had been telling us for years that all orders had to go to the primary market very quickly found the way to the various regionals, none of whom had suspended trading, to have their customers' orders executed. They found us when they had to.

LOVELACE: I would like to go back for a minute to the two points that Don Feuerstein mentioned made him angry, and talk about the first of the two, the heavy flow of money to the institutions. That is really a factor of the most recent period. If you go back to the period 1960 to 1968, the growth of stockholdings of individuals compounded at about 11 percent per year over the eight-year period. It is the same for institutions and for total stock outstanding. The dramatic difference in proportion between institutions and individuals has occurred since 1968, and directly parallels a period in which total commissions in the general securities business have gone down and firms have left the business. I think that still may be something of a debatable item, on a long-range basis; but I think that the number of firms in the business and their profitability probably are related importantly to the proportion of the volume accounted for by the individual investor vis-à-vis institutional investing.

McQUOWN: My first comments here pertain to those by Don Feuerstein. I think I heard him asserting a causal link between the current financial difficulty of utilities, transportation companies, etc., and the institutionalization of investment capital. If so, he may not realize that the problem with those companies is that their return on investment is competitively low. Both individuals and institutions direct their capital through existing market mechanisms to investments according to their perceived attractiveness. I doubt that the capital-raising mechanisms themselves are even indirectly related to the apparent low expectations for those companies. I find another causal hypothesis more probable: the financial difficulty of those firms stems from government controls on prices, regulated entry, and restricted freedom to act or innovate. The result: those companies no longer offer competitive returns and therefore can't raise capital—individual or institutional.

Second, I have a question about the reasons for institutional membership on regional exchanges. There are at least three advantages offered to the institution: reduced commission expense, market making, and clearing-depository. Negotiated rates will most probably reduce the incentive of institutional membership for the first reason. But why wouldn't institutions still be interested in the latter two? And, what about innovations, couldn't they attract institutional members?

DOWD: With fully negotiated rates, there will be very little incentive for an institution to have membership, even apart from the requirements of Rule 19b-2, which at present requires them to obtain at least 80 percent of their business from unaffiliated sources. This is not to say, however, that all institutions will have to get out. It may well be that Phoenix, which is on the floor at PBW and has committed up to half a million dollars, more if necessary, in market making as a specialist, will desire to continue this activity as a separate profit center. Other institutions may find this prospect attractive, not to save money on their portfolio brokerage, but to operate a regional specialist book as a profit center. We hope that other institutions will consider this possibility in the future.

RICKERSHAUSER: In his question about execution, Tom Lewis referred to "the regionals" as though they were a homogeneous group. Everyone else tends to lump the regionals together semantically as well. Yet we all do know that different regional stock exchanges are different. On the Pacific, during the month of October, two national wire firms hooked up with the automatic execution service that accounted for approximately 30 percent of total transactions volume. The automatic execution innovation is one of the reasons you can get a slightly more optimistic tone from Bob Ackerman than you could yesterday from Barry Tague. Those wire firms obviously are executing because they think their customer is getting a good execution, while they are doing it cheaper. Now, the trouble is that, no doubt, New York will eventually come up with a similar execution system; so we will just have to stay a step ahead of them.

LOOMIS: I was going back to Tom Lewis's question in his exchange with Mr. Ackerman. Where have the regulators been all this time? The question has been raised, over the years, as to why some of these wire houses set up their switching systems so that the issues went automatically to the floor of the New York. The answer you always get, or got, was that New York was, as it calls itself, "The Exchange." It was presumed that every customer wanted his order executed on the New York Stock Exchange unless he specified, in advance, to the contrary; and the wire house expected to have lots of explaining to do if it executed a customer's order anywhere else. But as Chuck Rickershauser has just said, that climate is changing, and with the composite tape and the composite quotes, I do not think that one can maintain any longer the doctrine that the customers never have heard of any exchange except New York.

PAINTER: I am still concerned. Don Feuerstein is a very good friend of mine, and I would not want him to go away from this helpful conference mad. I would like to ask him, although it is true that a substantial amount of primary investment is, as he says, being channeled through institutional sources today, is it not also true, as Sidney Homer pointed out to us, that increasingly, individual or private investors are investing not in stocks, but in good-grade bond issues? This of course speaks well for the individual private investor. All I am suggesting is that possibly what we are seeing is a shift out of equities into bonds.

FEUERSTEIN: I think that is taking place.

MINTZ: Back to Tom's question. I think one of the problems with the quotation system might be that if one goes down to the floor of the Pacific Stock Exchange with a small order of a hundred or two hundred shares, one might find that by the time he gets there, the quote is gone and he could have done better in New York. However, I think I would be inclined to advise my brokerage clients to have a written procedure requiring that their order go to where the best market is, as indicated on the quotation system. I would include regional exchanges only if the brokerage firms could be assured of receiving the next print in New York following receipt of the order on the floor of the regional exchange.

ACKERMAN: That is essentially the guts of the Comex system whereby all orders up to 199 shares (this is the system Chuck Rickershauser and Phil Loomis referred to) are processed automatically, untouched by human hands, through a computer and executed at a price based on the next New York print. There is a formula involved, depending upon whether the next print is a plus tick or a minus tick. A recent study of ours took a sampling of a hundred executions that occurred on Comex and found that all of them were equal to or better than they would have been had the order gone directly to New York. On 43 percent of the trades they were better.

MINTZ: I think the quotation system will go a long way toward getting an order flow to you. Integrating the system that you now have will create a certain degree of reliability that one will get in an execution as good as, if not better than, on the floor in New York.

ACKERMAN: Isn't it true, and I guess this is a basic fact of life, that if each market maker has available to him the quotes on markets that are made in other places, and a floor broker comes up to him with an order, for example, in New York, and the quotation on a regional may be the better quotation than he is being shown by his New York specialist, is it not a fact of life that the New York specialist might be inclined to change his quotation in order to keep the business on that floor? I'd expect us to wind up with a series of marketplaces in which quotations are going to be virtually indentical.

MINTZ: That may happen with brokers on the New York floor. As to the client out in the hinterland, however, he does not yet have that communication with the New York specialists; they are basically going to be looking at the quotation system, certainly in the trading department of the firm.

ACKERMAN: It will be going through the floor broker on the floor in question, however, and he will be aware of markets on other floors. It will be at the floor broker's discretion, not at the specialist's discretion, as to where the order is executed.

MINTZ: The hope is that that decision might be made in the trading department of the firm. If not, it would have to go to the floor broker in New York and then get shipped back.

ACKERMAN: The hope is it would be made by the firm itself based on the best interest of the customer; or by the customer himself by designating the marketplace in which he chooses to do business, either because of tax reasons, as we discussed before, or for any other reason.

MINTZ: A brokerage firm should consider with its legal counsel the content of written procedures which may be adopted in connection with a composite quotation system.

IRELAND: In my continual effort to keep the "real world" of trading before the group, I would like to make a couple of comments as to how we are going to be affected next year. The industry has set up a composite tape that probably will run much faster than we can read. They are coming up with the composite quotation system, but it is unclear whether or not we will really have it on our desks. You developed a system of negotiated commissions, in which, after we have done the trading we will have to try to negotiate a commission, which would naturally bind us because of fiduciary requirements. We are going to have to make public certain of our large holdings and transactions on a quarterly basis, which will open us up to a certain amount of criticism. I just hope that we do not have too many more improvements.

LEUKER: Commissioner Loomis alluded to this, and it is one thing that has not been discussed too much here. In an over-the-counter execution, especially since the advent of NASDAQ, it is fairly simple for the trader or the order clerk handling a public order to obtain best execution. The client, when he receives his confirmation, just notices that it was sold over the counter with the broker acting either as agent or as principal. But the thing I have been fighting for during the twenty-eight years I have been with a regional firm is the matter of education. We still have orders that we receive either from our registered representative or from our clients saying, "This order is to be executed in New York only." It so happens that our computer channels all dually listed orders to our man on the floor of the Pacific Stock Exchange, and he makes the decision, based on where the client can obtain best execution. If the specialist on the Pacific Exchange cannot execute that order on the next sale, and if he is unable to protect it, the order is shipped immediately by our wire to New York. Believe it or not, very little time has elapsed. We do not waste that much time. Nevertheless, the educational process to the registered rep and to the client, under a central market system, is to convince them both that an order executed on the Pacific, or Midwest, or third market was the best execution. It is still, I think, a very difficult thing to do, and a vast educational program has to be developed.

WEEDEN: Bob, isn't what Clem just said at the heart of all our problems? We have to re-educate people on this concept of primary and secondary markets. The composite tape and the quotation system are going to go a long way in doing that. It might end up that because we are not as good as we think, and can't maintain our competitive position either in market making, clearing, communications, or access, all the business will end up on the New York after all. But for the first time we will have an opportunity not only to educate the public that there are other competitive markets, but even our own membership. In the way that Jay Mintz asked the question—if I go to the Pacific Coast I might miss the market in New York—it could just as easily be rephrased the other way, as—if I go to New York, I might miss the market on the Pacific Coast. Now, you do not think of it that way because New York is the primary market; but for you, it probably takes longer to get to New York and find out that the quote no longer is any good. It also costs you more to go out there, you as a broker; so once we get the tape and the quotation system even you might change your attitude that your customer will be better served by taking the risk of going to the Pacific Coast before trying the New York. You might end up finding that even though the Pacific Coast is outside the New York range, the net cost to the customer will be just as good as if the trade had been done in New York; and for the first time you and your customer will be satisfied with executing on the Pacific Coast, outside the NYSE range, which you will not do today.

ACKERMAN: With your usual, unerring accuracy you have managed again to pinpoint the heart of the problem. It is very definitely an educational process, one that is not only long in coming, but also will not be accomplished easily or overnight. We have our own investment community, in addition to the public. I am not sure which has to be educated first. I would probably be inclined to think that it would be our own investment community, meaning the registered representatives, the branch office managers, and on up the ladder, who most need to be educated on this topic. The elements of the central market system, some of which we have discussed here, I think go a long way toward helping that educational process come about.

RICKERSHAUSER: I want to make a statement. I noticed in the program it says we are going to have an open discussion period. I assume that anyone has a right to make a statement without necessarily offending anyone else. I am impressed by the importance and potential of the automatic execution facility developed by the Pacific Coast Exchange. In my thinking it is an important first step toward what the central market system is all about. It provides an answer, eventually, to the guarantee of best execution, and to the way the regional exchanges can eliminate their inferiority complex, which is now very pervasive. If the various regional exchanges each develop an automatic execution system on their own floor and then tie them together with a quotation system, their various specialists will have priority and precedence in terms of where an order goes. If a wire house sends an order into that system, and if there are several quotations at the same level, it will automatically go to the market maker who got there first. It will then be possible for any regional market maker to have an opportunity to attract business by being "first" with the "best" price. That is what it is going to take to make a real central market system for public orders.

For a long time nobody thought that there ever would be a central market system, of that sort, for institutional trades; but if there are four, five, or six market makers operating under such a system, I can imagine that the progression from 201, 250, or 300 shares and from five, six, or seven market makers will occur very rapidly, and will permit us to get good, automatic execution for orders up to 1,000 or 2,000 shares in the not too far distant future. I think it could be developed beyond that, but in any event we then will have something that can truly be called a central market system.

ACKERMAN: To answer your question, first, there is nothing magical about the 199 figure. Obviously this could be handled as an odd lot, automatic execution system only, but was expanded to 100 shares plus the odd lot, up to the 199-share position. The disappointing part of this discussion to me is that it appears the Pacific's automatic execution system comes as somewhat of a revelation to many of the persons here, despite the fact that it has been in operation for some four or five years. Probably this is one of the Pacific Exchange's least desired but best kept secrets.