1970

Eugene H. Rotberg, previously Associate Counsel of the Securities and Exchange Commission, spoke informally about the concept of a Central Auction Market. His remarks are summarized below:

I think most of us are likely to agree that the reason for the concern about maintaining the "Central Auction Market" has to do with the fact that orders are often brought to places other than a major securities exchange because one of the parties to that trade, perhaps the customer, wishes to make use of a more flexible commission rate structure. The transported trade may benefit the customer, perhaps the manager of a trust or a third party or a combination of all three... or sometimes it is used simply to repay non-members for business for which they were not compensated as non-members of the New York Stock Exchange. The execution of certain trades off the New York Stock Exchange is an outgrowth, to a major extent, of a fixed rate system, limited access by non-members and rather restrictive rules as to who can share commissions.... But be that as it may, the place of reporting an institutional order has minimum relevance to the providing of liquidity. If there were a rate structure which permitted institutions to negotiate commissions at a lower level than now permitted, or if there were meaningful access for non-members, there would be little reason to bring most institutional orders other than on the New York Stock Exchange, or to engage in the myriad of reciprocal arrangements designed to siphon commissions from member firms.

And members, as a group, historically have not complained about the transport of trades; about the reciprocity; about the give ups; about the

avoidance of the "Central Auction Market", because until recently the commissions were being divided among securities firms - albeit a widening category. When, however, trades are executed in a manner, or by entities, which draw down commissions for dissemination to customers, then the arguments become very public policy-oriented - and there is much talk about a Central Auction Market.

The members of the New York Stock Exchange and other dealers provide great expertise and capital to assist in developing liquidity and for that they deserve the utmost compliment; they are not served well by talk of the Central Auction Market as if that expression, rather than they, provide liquidity.

Nor is the term "dealer market" a useful concept. It has often been used to distinguish the listed market from the over-the-counter market. Yet the dealers on an Exchange, such as specialists or block traders, are pointed to as major strength of a securities exchange.... There are constant efforts to provide them with incentives or capital to permit them to perform their dealer function more efficiently. Various exchanges have encouraged the use of retail firms to become dealers on the exchange and great credit has been given to the superb member firms who have become dealers in that they have put up their capital at risk to absorb large blocks of listed securities. Who now can so easily forget and reject the arguments to preserve floor traders - dealers for their own account, or the very useful efforts to relax credit restrictions to facilitate dealer activity?

...So, I have difficulty understanding the attempted distinction

between the over-the-counter market and the listed market on the basis of one being a dealer and the latter an agency or brokerage market. Both markets have major elements of both kinds of trading. Yet, we hear much of this term along with the "Central Auction Market" to describe an environment which is to be preserved or strengthened or weakened depending upon the interests of those concerned.

Dealers are important. Capital is important, whether it is member firm capital or non-member firm capital; whether in the over-the-counter market or the listed market. The idea, however, that if somehow all the regional exchanges and the third market were linked, that would create liquidity, I suspect, is naive. The liquidity is made up of the capital of the dealers, their expertise and their willingness to use it. The communication links are there; economic access is lacking.

Nor does the use of the term "auction" provide us with answers. An auction, in the securities markets, contemplates that there are orders left on the book and that the highest bidder or lowest offerer represents the prevailing quotation. But does that mean that the spread between buyers and sellers on a national securities exchange is narrower than in a marketplace where there are no limit orders or central location for holding orders? It may be useful to determine whether the spread between all public buyers or sellers for a listed security in, say, one hundred share lots is wider or narrower under a system of one specialist, as compared to a security with similar volume in the over-the-counter market where there are perhaps 10 specialist dealers, but where there is no "book" in the technical sense.... Nor is the term "auction" applicable to much of the trading on securities

exchanges, even assuming the term has some regulatory significance. Odd lots are not part of the auction. Nor are opening prices which are set after evaluating all the open market orders, all the limit orders.... the specialist looks at the last sale the night before and the tone of the market, evaluates his own position and opens with a price. Clearly that is not an auction. Those who place market orders have no idea what is the specialist's position; they have no idea what limit orders have come in; they have no information as to the number of buy/sell orders, or their imbalance. In terms of price they are in the dark; they do not have a quotation. This is not to say that this is unfair or inappropriate. The point is that however you might label it, it is not an auction.

If I were to describe a market where dealers compete, where they communicate with each other, where they take positions, where they offset their position by distributing to the public, where most liquidity for larger blocks is essentially derived from institutions who negotiate prices, I suggest that half of this audience would ascribe the description to the over-the-counter market; the other half would argue that I have described the exchange market for listed securities....

Nor can the execution of blocks be said to be encompassed by the term "auction".... I suspect there is little difference between the way a large block of listed securities and over-the-counter securities is handled in terms of the way a member firm acts and how it is actually placed. The firm negotiates price between a buyer and seller. When price is agreed upon the order is reported on the floor. Though the firm may lose shares to the book, or to the specialist, which may be particularly desirable

if the member itself is taking a position, the primary suppliers of the liquidity, however, are other institutions or dealers... all part of the "auction".

Could it be that the real concern is to make sure that rules or procedures are not developed which permit important customers to cut commissions? I reluctantly come to that conclusion. It is with great reluctance that I have reached the conclusion that terms like "dealer market", "Central Auction Market", are used to mask a hostility to a potential threat... threat from the regional exchanges and from the third market. The threat is that each has developed and will develop methods of introducing price competition either through reciprocity, institutional membership or by negotiating rates directly. The threat has little to do with liquidity but a lot to do with reducing commissions. Stated another way, I suspect that all the intellectual debate about regional exchanges and the economic efficiency of the third and the central market would disappear if the third market agreed to charge fixed minimum commissions, or their equivalent, and if the regionals agreed to forego reciprocal practices which draw down commissions from lead brokers,... and if they agreed to forego soliciting institutional membership.

It is unfortunate that the very difficult question of negotiated rates which, I suspect, is at the heart of the matter, is being finessed and is not receiving the attention it deserves because of attempts to frame the question of "institutional membership" and "access of non-member dealers". (which in turn are outgrowths of the failure to cope with the

question of negotiated rates) in terms of some public policy-oriented context, like the economic efficiency of a Central Auction Market.

I would suggest that the problems raised by the question of negotiated rates should be examined head-on and not be resolved, indirectly, by talk of a Central Auction Market, which would require, by definition, one set of rules and little room for maneuvering by errant regionals or non-member firms. If there should be no further lowering of the breakpoint on negotiated rates that issue should be faced directly and not cloaked in policy arguments about the efficiency of the "auction" or the concentration of economic power of institutions. The issue of concentration of economic power by financial institutions itself is most complex; about the only comment I can make on it here, is that there is little less relevant to the resolution of that matter than whether these institutions can become members of stock exchanges in order to save a few dollars for their beneficiaries.

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