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To Our Clients:

The Martin Report - Some Random Thoughts

The Martin Report will be a major factor in the immediate and continuing restructuring of the securities industry. It may be expected to have significant influence on the NYSE Board of Governors, the SEC and the current House and Senate hearings. The impact will be felt not just in the brokerage business, but by institutional investors and all segments of the securities industry. Thus, it is a vital consideration in planning. The following are initial personal reactions and speculations occasioned by some of Mr. Martin's recommendations.

National Central Market System. The basic premise of the Martin Report is that computer and communications technology make possible a national central market system composed of a national exchange (with divisions to reflect NYSE, AMEX and perhaps other listing standards) and a national OTC market. Each market would be exclusive. Third and fourth markets would not be permitted. The NYSE should be reorganized and eventually become the national exchange system, absorbing in the process the regional exchanges. The floor and assigned market-maker specialists would continue.

The technology for the national central market is now available. NASDAQ-Instinet-type systems with tape reporting with a tie-in to transfer record computers of the central transfer banks would create a national market with instant reporting of all trades and "locked in" trades with a net balance settling mechanism providing computer generated confirmations and ledger entries.

In addition to the certificate, such a central market system probably would eliminate the floor. The central computer would replace the specialist's book. The specialists would become regulated market makers. There would be combinations of specialists and block houses. The exchanges' staffs would become the administrators of the system. The value of seats would be preserved, following Mr. Martin's recommendation, by conversion into stock in the system. The SIPC/FDIC analogy would be completed with industry ownership of the system similar to the banks' ownership of the Federal Reserve Banks. It is, of course, not surprising that so much of Mr. Martin's basic restructuring seems to be drawn from the example of the Federal Reserve System.

The practical and economic advantages of a national market mandate eventual implementation. Whatever the precise shape, it seems reasonable to conclude that the national market will be here in the not too distant future.

Institutional Membership. It is difficult to rationalize the proposed national market system with the exclusion of institutions. It is equally difficult to rationalize Mr. Martin's recommendations as to fixed commissions and exclusion of institutions. While adoption several years ago of negotiated rates for all trades might have stemmed the tide of institutional membership, and the third and fourth markets, integration of functions has progressed so far with so many members of both the brokerage community and the institutional community as to make it difficult to believe that it can be reversed. The economic and psychological investment is now so great that it appears more likely that the end result will be both institutional membership and a lower break-point on negotiated rates. This would satisfy those institutions like IDS who are committed to membership and also those like Fidelity who believe membership creates an inherent conflict and are committed to management only. The Moses v. Burgin recapture problem could thus be solved either by entry into the brokerage business and sharing the profits or by utilizing negotiated rates to achieve a similar end. This also would obviate the need for the illogical (and on the record not justifiable) separation of brokerage from fund management

(but not other management) in order to justify exclusion of institutions; such separation being a particularly difficult problem in light of the implications of Rosenfeld v. Black.

As Mr. Martin recognizes, fixed commissions and exclusion of institutions raise serious antitrust questions. The court decisions have been adverse to the NYSE and may be expected to continue to be adverse. Mr. Martin recommends legislation to achieve antitrust exemption. This is desirable. However, if it is attempted in the context of fixed rates and exclusion of institutions, the strenuous opposition on these issues creates the danger of regulatory legislation of the type which has stifled the railroads, shipping companies, airlines, etc. A very poor trade to accomplish something that the new technology appears to invite in any event.

Capital. Mr. Martin's recommendations, like the 1970 legislation and the soon to be promulgated SEC rules, presage the need for larger permanent equity capital. Debt ratios will narrow and larger and larger reserves to protect liquidity will be required. Use of free credit balance and customers securities for short-sale borrowing will be restricted.

Structure of Firms. The new structure of the industry will remove the commission umbrella from services performed for institutional investors. Moses v. Burgin precludes use of investment company portfolio brokerage to "pay" for sales and may perhaps preclude its use to pay for research. Similar fiduciary considerations affect other institutional investors. Thus, a trend away from the use of brokerage to pay for other services.

Central sources of research to avoid wasteful duplication of effort and to service smaller institutions will continue to be desirable. Research firms or the research divisions of brokerage firms will provide their services for "hard" dollars. The closest analogies are legal services and management consulting. The direct cost of investment management, no longer subsidized by the use of portfolio brokerage to pay for services, will increase. So too will management fees. The net overall cost will remain constant or decline as the result of lower commission costs and the change in management attitudes as a result of switching from "soft" to "hard" dollars. There will be a major expansion in the number of investment advisory firms.

Institutional membership and the combination of specialists and block houses will result in a new wave of acquisitions and mergers. For those who plan to participate in the mergers, it is probably desirable to go public now.

While denied in part and largely ignored in the Martin Report, the problem of the retail commission salesman and churning, will undoubtedly receive congressional attention. Politics makes the public investor a better issue. A large number of churning-type lawsuits stemming from the 1969-70 downturn are just now reaching trial. The problem may well receive considerable notoriety from strong court decisions while the congressional hearings are in progress. (Hearings in the hands of staff directors who are not sympathetic to the industry.) Those who favor separation of brokerage and fund management may find that separation has been carried to the extreme of the 1933 recommendation for the separation of the broker function from the dealer function and the separation of all advice from transaction execution.

These speculations are tendered as such. The diverse and irreconcilable interests of the major firms and institutions preclude reasonable predictability. The practical and economic validity of the central theme of the Martin Report cannot be denied. The central national market system probably cannot be too long delayed in implementation. The ancillary issues will then be determined as much, if not more, by the dictates of the system and its technology as by politics.

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