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STATEMENT OF
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BEFORE THE
HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
AND
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE

ON

THE COMPTROLLER GENERAL'S REPORT: [IMPROVEMENTS NEEDED
IN THE SECURITIES AND EXCHANGE COMMISSION'S EFFORTS TO
ESTABLISH A NATIONAL SECURITIES MARKET]

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Mr. Chairmen and Members of the Committee:

We are pleased to be here to discuss with you our recent report on management improvements needed to guide the Securities and Exchange Commission's efforts to establish a national market system for trading securities.

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✓ In 1975, the Congress passed the Securities Acts Amendments of 1975, which directed the Securities and Exchange Commission to bring about a national market system for trading securities. The purpose of this act was to assure that all buyers and sellers of securities, regardless of their geographic location, would have the opportunity to get the best price when they trade securities. The Congress provided the Commission with broad, clear power and discretion to shape a system that met congressional objectives. These objectives were to assure that:

--securities transactions are executed economically and

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*Marketing
Trade
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efficiently;

--fair competition exists among market participants;

--information on price quotations and securities transactions is available to brokers, dealers, and investors;

--brokers can execute investors' orders in the best market; and

--the opportunity exists, consistent with economic efficiency and best market execution, for investors' orders to meet without the assistance of a dealer.

Further, the congressional objectives for the national market explicitly require that modern data processing and communications technology be used to improve operational efficiency and to enhance competition in the securities industry.

Neither the Congress nor the Commission has further defined what the national market should be. However, according to various industry representatives a national market system could make information and processing facilities available for securities trading. Such facilities could:

--provide all market participants with up-to-the-second information on securities prices throughout the country,

--enable trading transactions originating in one market to be sent to another to obtain a better price, and

--temporarily hold orders which are to be executed at prices that may differ from current market prices.

As a result of your 1977 joint hearings, your Subcommittees concluded that the Commission had not vigorously exercised its authority and directed the Commission to take whatever steps were necessary to put the system into operation.

Today, approximately four years after the passage of the act, there is not a national market. When will it be completed? No one knows; none of the congressional objectives for the market have been fully met. How far along is progress? No one knows, but the the Commission states that much remains to be done. How will the market look when completed? No one knows because the Commission has not defined what the scope or structure of the system will be when it is completed.

In short, the Commission has not developed an overall plan to guide development of a national market and to monitor progress toward that goal. Without a plan, claims of progress or statements concerning the completion of a national market are not based on objective determinations because there is no way to compare what was done with what was intended to be done.

Although the Commission has not developed such a plan, various actions have been taken which industry observers consider important steps toward a national market. For example, the Intermarket Trading System, a communications connection between six stock exchanges, began operations in April 1978. However, it is acknowledged by the Commission officials that this is only a potential component of a national market system and does not represent significant progress toward such a system. In this respect:

--Information from four of the 10 exchanges and the over-the-counter market is not included.

--Each exchange has to be queried separately. Because each query can take as long as 2 minutes, as much as 10 minutes is needed to contact all participating exchanges. Commission officials consider this system a more efficient communications device than the telephone, but a marginal improvement. They also believe the system does not provide a means for more effective competition among markets.

--We were told there were technical problems with the system, and when it was demonstrated for us, it did not work properly for some of the transactions attempted.

--The Commission stated that the lengthy time required to enter data into the system's computer terminal discouraged use of the system when trading was heavy.

The Commission has also approved the use by the Cincinnati Stock Exchange of a fully automated electronic trading system that relies on a central computer to match buy and sell orders. In 1978, an independent firm of certified public accountants was commissioned by the Cincinnati Stock Exchange to evaluate its system. One of the findings of this firm was that the system had four components of a national market as viewed by the Cincinnati Stock Exchange--a composite quote system, an order-routing system, an intermarket communication system, and a

central limit order file. This evaluation also found that orders could be executed within 30 seconds. However, the system has not been extensively tested, and the Commission has asked that more use be made of this system. In our visits to several market locations, we found that some of the terminals for the Cincinnati system were not even turned on.

In the absence of a Commission plan, however, it is not possible to determine how these two systems could be used together, whether one would be phased out and the other take its place or just how the Commission would bring the various projects together into a cohesive national market.

In order to complete our work in time for these hearings, we did not develop estimates on the savings which would result from a national market. However, the Stanford Research Institute, an independent research organization, conducted a comprehensive review of the securities industry in 1976. One of the conclusions of this study was that a national market which used modern technology efficiently could save market users up to \$100 million annually in reduced operating cost. Other estimates place annual savings at about \$50 million.

Lack of a plan creates uncertainty in the industry as to the direction the Commission will take. Over the next 2 years, three of the stock exchanges we visited plan to spend about \$18 million to improve their operating facilities. These operating facilities which the industry is developing may have to be altered or discarded if they are not adaptable or do not contribute to the national market system.

The Commission's long experience in regulation influences its national market efforts. To bring about a national market, the Commission is using "evolutionary" procedures. Under this method, the Commission requests, or it can order, industry groups to design system components that will fit into those already in place.

We do not believe this piecemeal procedure is an effective way to develop a system as significant as the national market. We recognize that system components can be phased into operation one at a time as they become available. But to be successful, this phased implementation must be guided by an overall plan to assure that the various components will result in an integrated system.

The type of plan we think would be needed to guide development of the system could, for example,

- provide for defining the market system and determining its requirements, including user needs;
- set forth policies to guide the development of the national market;
- determine the components that are to comprise the system and establish milestones for bringing them into the system;
- determine the Commission staffing resources needed to carry out management responsibilities relative to the system; and
- call for the development of management processes to identify problems and monitor progress.

A top Commission official has observed that overseeing the development of the national market has given the Commission new mandates which go beyond its traditional responsibilities and has placed the Commission in an unaccustomed role. We agree with this view.

Using its regulatory approach, the Commission took six years to bring about a system component which enabled investors to see the prices at which other markets are willing to buy or sell securities. It took the Commission 4 years to get a component established which showed the prices at which stock-exchange-listed securities were sold.

Industry sources stated that both components could have been placed in operation within 9 months.

The Congress found that modern data processing and communications technology provided the means for obtaining a national market. The personnel assigned to the Commission's national market unit do not have the technical skills needed to evaluate industry proposals dealing with sophisticated data processing systems. The need for technical advice is shown by the following examples.

--Six years elapsed in putting into operation the composite quotation system which gives the prices at which other traders are willing to buy or sell securities. However, when the system started operating in August 1978, the communication lines lacked sufficient capacity to carry the volume of data created during periods of heavy trading. As a result, twenty minute delays were experienced when

up-to-the-second data was needed to give effect to fast changing market prices.

In November 1978, the Commission Chairman stated that such delays were unacceptable and undermined the usefulness of the system. In March 1979, the Commission re-emphasized the need for further improvement in the timeliness and reliability of the system and expressed concern that revised quotations from certain exchanges were not being disseminated in a timely fashion.

--As I discussed earlier, the Commission approved the Intermarket Trading System in April 1978. In March 1979, the Commission said that the lengthy time required to enter data into the system's computer terminal discouraged use of the system when trading was heavy.

We believe that with an adequate technical staff, the Commission would have been in a good position to detect these problems and take steps to avoid or minimize them.

The size of the Commission's national market unit also does not appear adequate to perform work on the system in a timely manner. Six attorneys are assigned to the unit. Only two of the 18 tasks scheduled in 1978 were completed on time. Commission officials believed that one year of on-the-job national market experience is needed. In April 1979, only two of the six attorneys met this proficiency standard.

Commission officials advised us that many other persons work on national market activities. We believe, however, that if the

work is to proceed rapidly, more staff should be assigned directly to the national market unit and a project management approach adopted.

Congress wanted national market trading to be conducted with accurate information supplied by neutral sources. As a result, Congress required exclusive processors of securities information to register with the Commission.

We reviewed the Commission actions taken to register the Securities Industry Automation Corporation. SIAC is the exclusive processor for composite quotations, consolidated last-sale reporting, and Intermarket Trading System data and, therefore, plays a key role in national market development. The reliability of its processing can affect investor trading decisions. Its determinations as to who may report data through its facilities, and in what manner, can affect the extent and nature of competition in the national market.

The Commission registered SIAC without independently verifying whether the firm could promptly process reliable and accurate data. Data processing experts told the Commission that findings concerning SIAC's data processing capabilities would require exhaustive on-site testing by a team of experts. Such testing was not carried out.

Moreover, the Commission did not assess SIAC's neutrality. The Senate report on the national market legislation states that the Commission is responsible for assuring the neutrality of exclusive processors such as SIAC, in practice as well as in

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concept. The New York Stock Exchange, by owning two-thirds of SIAC's stock, is capable of exercising control over all of SIAC's activities. In September 1978, the American Stock Exchange, which owns the other third of SIAC's stock, told the Commission that the New York Stock Exchange's vast economic resources and concentration of capital combine to give it unmatched advantages. The Commission has not conducted any evaluations of SIAC's activities and does not plan to in the near future.

In summary, we believe that proper planning of national market activities would provide for prompt and effective completion of an integrated system. As Chairman Eckhardt pointed out in 1975, he would reserve to Congress the authority to say whether a national market plan meets its approval. In line with this interest in the development of an appropriate plan, we have made three recommendations to the Congress in our recent report on this subject.

First, we believe the Congress should require the Commission to develop and submit a national market plan to the Congress by a specified date. At a minimum, the Commission plan should define the system and its requirements, assign responsibilities for designing components and include an implementation schedule.

Our second recommendation is that the Congress give interested parties the opportunity to present their views on the Commission's plan. This action should bring out the good aspects of the plan as well as those areas where improvements may be needed.

Our third recommendation is for the Congress to establish a time frame for designing and implementing the national market. In essence, this action should provide the basis for measuring national market progress. Also, such action would better enable the securities industry to plan and prepare for national market development.

Also, to provide greater assurance that the national market system will be developed promptly as desired by Congress, we are also recommending that the Commission take action to improve its staffing by establishing a national market project team having enough technically-oriented members to carry out its responsibilities.

In addition, we believe the Commission's regulation over processors of national market information should be strengthened. To be responsive to congressional intent, we are recommending that the Commission have SIAC's processing facilities for national market transactions evaluated by a team of data processing experts and that an evaluation program be developed to assess the status of SIAC's neutrality. We are also recommending that any other exclusive processors be subjected to the same evaluations.

Mr. Chairmen, this concludes my prepared statement. We shall be happy to answer any questions.