UNITED STATES DEPARTMENT OF JUSTICE

WASHINGTON, D.C. 20530

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April 24, 1975

Honorable Ray Garrett, Jr.
Chairman
Securities and Exchange Commission
Washington, D. C. 20549

Dear Chairman Garrett:

The New York Stock Exchange ("NYSE" or "Exchange") has submitted to the Commission proposed amendments to Rule 394 of the Exchange. The present Rule, as the Commission is well aware, severely restricts the ability of member firms to trade listed securities off the floor of the Exchange. The NYSE asserts that the proposed amendments would ease the requirements associated with going off the Exchange and thus permit members to trade listed securities in the third market in particular instances where a member can show that better executions for customers would result.

We have reviewed the proposed amendments carefully and offer the following views for the Commission's consideration. We request that they be made part of the public record. These views are based upon our review of the Rule, the studies of the Rule's background and effects made by the Commission's staff in 1965 and by Congressional Committees more recently, and discussions with securities professionals from the NYSE and the third market. We also have had discussions with members of your staff on the proposed amendments.

The Department of Justice has long expressed the position that Rule 394 constitutes an unreasonable boycott of third market makers, 1/ and that the Rule should be abolished. 2/ We urge the Commission to consider those statements in addition to this letter.

The Department's fundamental point is that the historic rationale of Rule 394 is anticompetitive and inconsistent with the broker's fiduciary obligation to obtain the best price for his customers. It was primarily designed to protect the NYSE's long-standing system of fixed commissions and to protect its specialists from competition. The proponents of the amended Rule have not clearly demonstrated any new rationale for retaining this restriction in an era of competitive commission rates and instantaneous electronic communications systems. The Commission itself has recognized this in saying that Rule 394 has no place in an efficient and competitive central securities market. 3/ In sum, this is not the time to extend the life of Rule 394, but to eliminate it. The Commission should protect competitive market making and best execution for customers by setting a specific and prompt terminal date for the elimination of Rule 394.

Background of the Rule

Although the history and purpose of the Rule are well known, we believe it is useful to review these, especially in light of the NYSE's repeated assertions about the usefulness and desirability of the Rule's continuation. The NYSE has a long history of attempting to prohibit its members from trading any NYSE-listed securities away from its floor. Initially, it prohibited members from trading

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1/ Cf. Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959).

2/ See, e.g., Comments of the United States Department of Justice on Intra-Member Commission Rate Schedules of Registered National Securities Exchanges, SEC Release No. 34-10751, at 31-43 (June 28, 1974); Response of the United States Department of Justice to SEC Release No. 8791, File No. 4-144, at 11-18 (March 20, 1970).

3/ Policy Statement of the SEC on the Structure of a Central Market System, at 61-64 (March 29, 1973).

dually listed securities anywhere -- which in practice meant on regional exchanges. In 1941, the Commission struck down the rule preventing members from trading dually listed securities on regional exchanges, emphasizing its anticompetitive effect. In re Rules of the New York Stock Exchange, 10 SEC 270 (1941). "At best," the Commission said, "the rule is an attempt by the NYSE to implement its minimum commission rule." 10 SEC at 292.

Thereafter, no off-board trading prohibition existed for a number of years. However, in 1957, with the third market becoming a larger factor, the NYSE adopted the original Rule 394. It prohibited Exchange members from engaging in over the counter trading of NYSE listed securities. This was a flat and total prohibition. In 1965 the Commission's staff prepared a detailed study. This study concluded that Rule 394 unreasonably restricted competition between Exchange specialists and third market makers; and that it "reflected a decision by the Exchange that all non-members be required to pay a minimum commission on the execution of any order to which they were a party." 4/ The report was particularly critical of the arbitrary manner in which the NYSE had regulated off-board trading. As a result of the staff study, the Exchange adopted Rule 394(b) to permit off-board trades under certain highly restrictive conditions. It is, however, incontrovertible that this procedure simply has not worked effectively. As the Commission concluded in 1973, it is "sufficiently onerous to discourage its use in most cases." 5/

The Proposed Amendments

The argument presently offered in support of retaining Rule 394-type restrictions is that they are necessary to preserve an "auction" market on the NYSE. However, this assertion, at the moment, is based upon speculation rather than evidence. Moreover, the proposed amendments should be considered against the background of economic protectionism and restrictive administration which have been the characteristics of the Rule. The Commission has eliminated the fixed

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4/ SEC Staff Study on Rule 394, at 204 (December 1965).

5/ SEC Policy Statement, supra n. 3, at 61, n. 67.

rates which were the main rationale behind the original Multiple Trading rule and the original Rule 394. The case for following the Multiple Trading decision here is, on its face, if anything stronger now. The proponents of the proposed amendments thus bear an extraordinarily heavy burden. All doubts and ambiguities should be resolved against them.

The proposed amendments (although not a model of clarity) propose three major changes. First, the current requirement that a member report to and obtain the permission of a Floor Governor before soliciting a third market maker would be eliminated. In view of the allegedly arbitrary manner in which this requirement has sometimes been implemented, its elimination is clearly desirable. 6/ The member must, however, make "a diligent effort to explore the feasibility of obtaining a satisfactory execution. . . on the floor. . ." This requirement lacks reasonable certainty which in itself could deter members from seeking better execution off-board and could be subject to abuse in enforcement.

Second, the proposed amendments would change the provisions of Rule 394(b)(5) governing the circumstances under which bids and offers on the floor could displace the non-member's bid or offer. As we understand it, intervening bids or offers by the "public" at the same or a better price would continue to take precedence over the third market maker. In addition, any member professional could displace the third market maker with trades for his own account provided that professional had expressed an interest in participating in the trade at an indicated price when initially informed that

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6/ In early 1973, it was reported that Chairman Needham announced that all off-board trades would require his personal advance approval. See New York Times, February 2, 1973, at 39, 42. We do not know whether this policy was in fact ever adopted and, if so, whether it still exists. Nonetheless, it suggests the highly arbitrary and capricious way in which the rule, no matter what it says on paper, could be applied, especially by those who might be inclined to preserve private monopoly privileges.

the third market would be solicited. The NYSE asserts, "The effect of the proposed amendment is that Exchange professionals would have first opportunity to participate in a transaction for their own accounts and could not 'second guess' the nonmember market-maker if his bid or offer were accepted." 7/

We submit that this in fact is not the case and that member professionals trading for their own account will still have a substantial and unwarranted advantage over the third market maker. Thus, when a member brings an order to the floor and announces an intent to go off-board, the member professional can "express an interest" at any price or prices which he believes might be obtained in the third market. If his judgment turns out to be correct he will then have an opportunity to participate when the trade is returned to the floor, although he has no obligation to do so. If it turns out that his expression of interest is at a price which can not be matched in the third market, the member professional is not required to hold his original bid or offer open when the trade is returned. 8/ Under the proposed amendment, there would not be any future penalty for the member's refusal to hold to his original expression of interest since he would still receive the same "first shot" on future trades under the provisions of the Rule. On the other hand, the third market maker must as a practical matter hold his price open for a reasonable period of time while the member takes the trade back to the floor as required by the Rule before completing the trade.

Third, the proposed amendment would delete the present prohibition on off-board trades where the nonmember solicited the member to participate in the trade. This restriction, which does not have even a surface plausibility or justification, prohibits certain types of off-board trades no matter

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7/ Letter from James E. Buck to Lee A. Pickard, October 4, 1974, contained in SEC Release No. 11151 (December 24, 1974).

8/ The reason for this is that the member's "expression of interest" is firm only at the "point in time" at which it is originally made. See letter from J. E. Buck to Lee A. Pickard, November 16, 1974, contained in SEC Release No. 11151.

how beneficial to the member's customer. Presumably it would prohibit a trade which could not be completed except in the third market if the third market dealer "solicited" the member. Elimination of this restriction is obviously desirable.

In summary, it would appear that the NYSE's proposed amendments to Rule 394(b) lessen some of the restrictions currently imposed by the NYSE upon the ability of a member to trade off-board. We remind the Commission, however, that the purpose of the present paragraph (b) was also to make it easier for members to trade off-board. In fact, the record demonstrates that this has not been the case to any significant extent. Thus, any inclination toward optimism over the proposed apparent loosening of existing restrictions is tempered by experience.

Rule 394 and a Fair and
Efficient Securities Market

The paramount interest is that of the investing public. What the public needs is the best possible execution in whatever market it may be available, be it an "auction" or a "dealer" market. This means that brokers, regardless of whether they are exchange members or not, should be encouraged to search for best execution in every market. Such a process will tend to sharpen competition in the vital market making function and thereby narrow bid-asked spreads.

Even with the proposed amendments, Rule 394 does not serve that end. It is strictly a one-way street which still imposes substantial extra burdens on NYSE members seeking to carry on transactions in the third market. It imposes no obligations on Exchange members to check prices available in the third market (which now can easily be done in many instances through use of NASDAQ) or for that matter on the regional exchanges.

The issue is an intensely practical one. The NYSE continues to use certain manual procedures in an age of instantaneous electronic communications. Because of this, the process of checking with the floor is slow by electronic standards. The member broker may check NASDAQ or another

electronic market with a flick of the finger. Even if he finds an exceptionally good price available, he cannot immediately contact the dealer and execute the trade. Instead, even under the proposed amendments to Rule 394, he must make two trips to the floor -- each requiring a telephone call to his floor representative who them must take it across the floor to the appropriate specialist post. These delays are substantial in an electronic age. Since, under the Rule, the NYSE market must always be checked while there is no comparable obligation on the member to check other markets, this lack of an instantaneous communications system encourages the execution of most trades on the NYSE regardless of what price might be available elsewhere.

A second practical problem with the Rule is that it appears to constitute an unjustifiable discrimination. While a member has to check the NYSE before trading in the third market, no such restriction is imposed upon a member trading on the regional exchanges. The only rationale for such a distinction would be that the requirement is unnecessary to protect the public since the regional exchanges are designed as auction markets. While the regional exchanges have auction market characteristics, they vary greatly in volume and composition of trading and other characteristics. As a result, we do not understand how it could be contended that a trade on a regional exchange automatically provides the public investor with greater protection than would a third market trade. 9/ On the contrary, as noted above, we have always contended that the rationale of the Multiple Trading decision is applicable to third market trading and thus inconsistent with the preservation of Rule 394-type restrictions.

In addition to restricting competition between Exchange specialists and third market makers, the Rule also clearly interferes with a member broker's fiduciary duty to his customer to obtain the best price available. Indeed, in 1936 the Commission itself stated that a well governed stock

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9/ Some "third market" dealers are specialists or alternate specialists on regional exchanges. This permits some NYSE members (who also belong to the regional exchange) to trade some stocks with some "third market" makers without using Rule 394. The pattern is of course highly uneven.

exchange should "recognize and enforce the duty of a broker to get the best price for his client, even though that price is only obtainable off the floor of the exchange." Edison Electric Illuminating Co. of Boston, 1 SEC 909, 913 (1936). Rule 394 is totally inconsistent with this standard. Moreover, the Rule, as a practical matter, makes it more difficult for a broker voluntarily to exercise his fiduciary obligation to his customer according to his own judgment. As discussed above, the Rule even with the proposed modifications imposes certain time-consuming obligations upon a member who thinks his customer can be benefitted by an off-board trade. In the brokerage business, time is often of the essence and a rule which imposes time-consuming burdens upon a member is likely to discourage a member from making the initial judgment that the customer's interest might be best served by an off-board trade. No amount of rationalization on the part of the NYSE that public customers agree to the rules of the Exchange, including Rule 394, when dealing with member firms can justify this interference with a broker's duty to his customer.

Both the Senate and the House subcommittees which studied the securities industry concluded in their reports that Rule 394 was an unjustified restriction on competition and must be eliminated. 10/ Indeed, the Commission itself has already stated that Rule 394 is incompatible with a central market system and must be eliminated "not later than the time when the composite quotation system is implemented." 11/ In view of the delay in implementing the composite quotation system, we believe the Commission should now set a definite date for the repeal of Rule 394. Indeed, elimination of the Rule should lessen the incentives to delay the prompt development of a composite quotation system. This in turn would go a long way toward achieving a true central market system in which all public orders are executed at the best available price regardless of market.

10/ Report on the Securities Industry Study of the Senate Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, at 104-105 (1973); Report on the Securities Industry of the House Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, at 126-127 (1972).

11/ SEC Policy Statement, supra n. 3, at 64.

In conclusion, the question for the Commission is not whether the proposed Rule 394 amendments could be made to work in a desirable and reasonable fashion, but whether they could be made to work in an unreasonable and perverse fashion. The best method of promoting an efficient and fair central market system is to remove existing competitive restraints. At the present time, there is no evidence that the retention of any restrictions of the nature of Rule 394 are either necessary or appropriate to the Exchange Act's goals of protecting investors and maintaining fair and orderly markets. If subsequent experience should, contrary to present expectations, indicate a public interest need for any type of restrictions upon off-board trading by exchange members, the Commission can carefully tailor the remedy to meet the needs of the public interest. In the meantime, there does not appear to be any place in an efficient securities market for an artificial restraint on the ability of brokers to trade where the best price is available. It is time for the Commission to implement this principle which it has already recognized in theory.

Yours sincerely,

DONALD I. BAKER
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