WEEDEN & CO.
INCORPORATED

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Securities and Exchange Commission
Washington, D. C. 20549

Gentlemen:

Rule 394 is to the investing public what the Blackout Rule was to the sports viewing public – league sponsored rules, erected to assure a full house for club owners. Both were collective boycotts pure and simple and both worked very effectively. But neither were remotely in the public interest.

What the Commission has to decide by September 2, 1975 is whether brokers who want best execution will have to continue to use regional exchanges like out-of-state motel rooms to get occasional access to the Third Market, or whether the Securities Reform Act of 1975 means what it says about removing barriers to competition.

The testimony has been taken, the reports written, the issues debated and the legislation enacted. The "fail safe amendment" of the 1975 Act affords the New York Stock Exchange all the protection it needs against the Third Market. There seems little anyone can add to the arguments already made. In clear language the Congress has directed the Commission to expedite the bringing about of a national market system by eliminating barriers to competition. Rule 394 is such a barrier. Ergo, Rule 394 must go.

We recognize the need for the Commission to move slowly on big issues in order to give the industry time to adjust to new ways of thinking and acting. But, if negotiated commissions, a truly big issue, could be brought about in five years, it is hard to believe that more than ten years are needed for the New York Stock Exchange to learn to live without Rule 394.

The Stock Exchange cautions the Congress and the Commission to make haste slowly. Those of us who believe in a national market system know that the costs of delay keep getting higher and higher. Handling costs simply have to be lowered or there will never be any reduction in commissions for private investors. The Commission knows that this means automating the trading and clearing processes as much as possible. Unless the Commission has in mind it will single handedly design the national market that means exposing the evolving system to the shaping force of competition.

Every time the Commission ducks or delays on Rule 394, stock exchanges, information processors and brokerage firms all over the country quietly decide to hold up further investing in research and development of new equipment and programs for automating the execution and clearing of routine orders on multiple markets, let alone working through the complexities of a nationwide book. The same thinking colors the recent decision to develop a NASDAQ listed stock quotation system without an execution capability. My own belief, which I have stated to the National Association of Securities Dealers, is that it will be difficult, if not impossible, to market that system unless it includes an execution capability. The stock reply, of course, is who needs a combined quotation system with execution capability so long as Rule 394 locks in more than 80% of the prime business?

The New York Stock Exchange's submission of July 2, 1975 cunningly argues for retention of Rule 394 "until a national market system comes into existence". The argument is utterly circular. What the Stock Exchange knows all too well is that there will never be, there can never be, a national market system so long as Rule 394 exists.

Stripped of all its cloying cotton candy references to protecting the public interest in an auction market, the New York Stock Exchange's real pitch is for government intervention to keep it "the chosen instrument" of the securities industry. Like Pan American embracing the CAB to avoid the rigors of competition from charter flights, the Stock Exchange wants the Commission to protect it from the Third Market which despite its name is now the second largest market in listed securities – larger than the Amex or any of the regionals. So far, the Stock Exchange has succeeded, but to those of us who see the future possibilities of a national market system complete with an automated book and competing market makers, the Stock Exchange resembles not so much a chosen instrument as another Penn Central, remarkable only because of its size. In this computer age with enormous daily volumes in listed stocks, the Stock Exchange's arguments in favor of its beloved crowd are largely a myth.

By blocking initiative and innovation by its own staff, not to mention its more aggressive members, the Governors of the Stock Exchange heighten the contrast between the high cost of doing business on its antiquated floor compared with identical trades its members can effect more efficiently on the regionals or with the Third Market. As we stated in our February 4, 1975 letter to Chairman Garrett, with fixed commissions out and negotiated rates in, Rule 394 has actually become an incentive for cost conscious brokers to give up New York Stock Exchange membership.

The Commission, of course, will want to assemble its own figures for its report to Congress, but we understand that execution and clearing charges on the Midwest Exchange are about 1/3 less than on New York, while those on the Cincinnati Exchange are about 1/2 of Midwest. For those institutions which deal direct, the Third Market costs are about 1/2 of Cincinnati. Put that all together and you get a saving on execution and clearing charges of nearly 80% on the Third Market compared with the New York Stock Exchange. So much for the old claims about economies of scale.

The Stock Exchange shrugs off those comparisons, arguing that while Rule 394 may be a bit of a burden, it is a reasonable barrier needed to preserve the fragile auction process from the alleged evils of dealer markets. Besides, it argues, those of its members who are cost conscious and really want to go to the regionals are free to do so under the Multiple Trading case, and those of its members who insist on best execution are able to meet Weeden on those regionals which Weeden has joined. Accordingly, says the Stock Exchange, while we are all in a period of transition, Rule 394 is a justifiable restraint of trade, necessary to make the Exchange Act work.

Such double talk ignores the Commission's power to insure fair and orderly markets and to protect the public interest under the broad powers of the 1975 Act and masks the Stock Exchange's true purpose of trying to limit the growth of competitive markets in the hope of forcing the evolving national market system back into the single national market concept proposed in its Martin Report. Behind all the dire predictions of disaster to the auction process is the same goal sought over the years to limit all trading in listed stocks to registered exchanges. The New York Stock Exchange remains wedded to a single national market, the same concept it repeatedly urged on the Congress from 1971 through 1974; and which the Congress firmly rejected in the 1975 Act.

Notwithstanding the clear language of the 1975 Act about enhancing competition among participants in the national market, the Stock Exchange reasons that, if the Third Market can be isolated and somehow absorbed, it should be a relatively simple feat thereafter to buy off the weakened regionals with exclusive allocations of specialty stocks and revenue sharing arrangements. Most regionals have boards dominated by New York members.

The votes will be there for affiliation or merger when the time is ripe. If New York succeeds, the regionals' only place will be as wholly controlled, if not wholly owned, subsidiaries of New York. Monopoly, urges the Martin Report, is the best protection for the public interest because a monopoly is so much easier to regulate. Admittedly the argument is attractive to some regulators, but it is not what the 1975 Act is all about.

The pernicious effect of Rule 394 is not apparent to the uninitiated. The results are best illustrated by the distorting effect the Rule has had and continues to have on Weeden's customer mix. Bear in mind, Weeden is a professional market maker that deals only with broker/dealers and institutional investors. On the bond side, the bulk of our business is with broker/dealers, while on the stock side, it is the institutional investors who dominate. The big difference is Rule 394. It has been a very effective boycott, limiting our contact with broker/dealers pretty much to business we can do on the regionals. With more than 80% of the prime listed business, the Stock Exchange is scarcely an infant industry in need of such government protection from a competitor with less than 10% of the business.

What the Stock Exchange now proposes is another rearguard maneuver, another Commission blessed amendment of Rule 394. This was the gambit used in 1966 with such success. Give the appearance of graceful procedural compromise, but do not give an inch in practice. The Third Market got badly hurt with the last Commission sponsored amendment which was supposed to streamline the process of getting Stock Exchange permission by members to go off-board for better executions. In fact the Stock Exchange's records show that Rule 394(b) effectively killed all off-board trading by member firms. The only present access for member firms to the Third Market is via the regionals. We trust this time around the Commission will be wiser and stronger.

Given the dismal record of the Stock Exchange on self regulation on economic matters, the Commission would do well to heed the recent words of its most famous past chairman and most loyal supporter. "Only if the SEC is actively and aggressively exercising its powers of review and approval can we be sure that. . . [challenged practices]. . . are being monitored in the manner which Congress intended." So said Mr. Justice Douglas on June 26, 1975 in the Gordon case.

We read the Securities Reform Act of 1975 as a clear mandate from Congress to the Commission to actively and aggressively exercise its powers of review and approval to eliminate barriers to competition. Rule 394 is plainly the most egregious barrier on the books, utterly without any redeeming social value. If the Commission wants to help expedite the national market system without itself taking on the task of designing the whole system, it must expose the dominant market to competition. Only then will New York make those improvements needed to retain its members and its market share. For an industry such as ours regulations is no substitute for competition.

Sincerely,

Donald E. Weeden