NATIONAL MARKET ADVISORY BOARD

May 19, 1977

Chairman Harold M. Williams
Commissioner Philip A. Loomis, Jr.
Commissioner John R. Evans
Commissioner Irving M. Pollack
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

Re: Off-Board Trading by Members of National Securities Exchanges

Dear Sirs:

On February 25, 1977, we wrote to the Commission expressing our tentative conclusion that "the Commission having found that off-board trading restrictions are basically anticompetitive, the Board concludes that the purposes of the Securities Exchange Act of 1934 (the "Act") do not justify exchanges maintaining such restrictions generally and indefinitely."

We understand that at a public meeting of the Commission held last Thursday, you decided to commence a proceeding looking toward the removal of off-board trading restrictions by January 1, 1978, and to include in the release announcing such proceeding a solicitation of public comment on issues which might have to be resolved in connection with the removal of restrictions.

At the Commission's meeting it was noted that the Commission is awaiting the Board's views and that the Board could be of assistance in suggesting the issues on which the Commission should solicit comments. In this letter the Board notes the rules and facilities which it, or a substantial number of its members, believe ought to be in place before the removal of off-board trading restrictions, and the issues which the Board believes ought to be examined more fully before such removal becomes effective. The Board recommends that the Commission solicit in its release public comment on these matters.

The Board has discussed at length the issues related to the restrictions on off-board trading by members of national securities exchanges. In addition to having the benefit of the discussion and analysis contained in Securities Exchange Act Release No. 11942, dated December 19, 1975 (the "Release"), and of the hearings preceding it, the Board has received submissions from and consulted with many interested persons regarding this subject. The following report, containing the views of the Board on this subject and the minority views of certain of its members, is based on the Board's discussions and consultations and is submitted in fulfillment of the Board's statutory obligations.

CONCLUSION

The Board agrees with the Commission's finding that off-board trading restrictions are a burden on competition and, as noted above, the Board has concluded that the purposes of the Act do not justify exchanges maintaining such restrictions generally and indefinitely. [Footnote: Section 11A(c)(4)(A) of the Act in effect requires the Commission to amend any exchange rule limiting off-board trading if it imposes "a burden on competition which does not appear to the Commission to be necessary or appropriate in furtherance of the purposes of [the Act]."] The Board recognizes, however, that the removal of these restrictions may have a profound effect on the manner in which listed securities are traded, and therefore believes that such restrictions should be removed only after certain additional facilities and rules are in place. There are divergent views among Board members, which are discussed below, as to whether and when particular restrictions should be removed, and as to which facilities and rules must be in place prior to such removal.

While enhancement of competition is an important goal of the Act, it is only one of several goals. Major goals of a national market system, as expressed by Congress, are (i) to preserve and strengthen the securities markets as an important national asset and (ii) to make use of new data processing and communications techniques to link all markets (for qualified securities). Accomplishment of the latter goal is intended, in turn, to serve to (a) foster efficiency, (b) enhance competition, (c) increase available information, (d) facilitate the offsetting of investors' orders "without the participation of a dealer," [Footnote: This goal, the Act states, is to be sought to the extent consistent with those described in clauses (a) and (e). All these goals are set forth in Section 11A(a)(1) of the Act.] and (e) contribute to best execution. All these goals, and not merely that of enhancing competition in market making, must be kept in mind in considering removal of restrictions on members' off-board transactions.

In light of these goals, the Board is concerned that the removal of off-board trading restrictions might lead to an increase in fragmentation of order flows in listed securities. Such further fragmentation could have an adverse effect on pricing efficiency and the ability of the best bids and offers to meet. Many members are also concerned that such increased fragmentation would affect adversely the existing level of limit order protection and make the implementation of any new means of protection more difficult. Many members are also of the view that the removal of off-board trading restrictions as to broker-dealers acting as principal in transactions with retail customers may lead to problems.

Because of these concerns the Board has concluded that the removal of off-board trading restrictions should be preceded by the implementation of certain rules and facilities.

The Board unanimously agrees that rules and facilities comprising an effective composite quotation system should be in place prior to the removal of off-board trading restrictions.

A substantial portion of the Board believes that, in addition, rules and facilities protecting limit orders to the maximum extent practical in a fair and equitable manner should be in place prior to the removal of off-board trading restrictions. [Footnote: The Board notes that while a particular level of protection may be the "maximum extent practical" at one time, a higher level of protection may become practical as time passes. The meaning of the phrase "maximum extent practical" as used by the Board is elaborated upon at page four of our letter to the Commission, dated January 25, 1977, regarding the establishment of a composite limit order book ("Limit Order Protection Letter"). See also our letter to the Commission of February 25, 1977.] These Board members believe the Commission should take affirmative action to ensure that such rules and facilities are in place prior to removal.

The Board is sharply divided on the question of whether concerns about further fragmentation and potential problems arising from firms dealing with their own retail customers as principal require, in addition to an effective composite quotation system, a prohibition on such dealings with retail customers in transactions involving "qualified securities". [Footnote: Criteria for determining which securities might be deemed "qualified" are discussed below. At least initially the definition would include only listed equity securities, and perhaps only those more actively traded.]

The Board unanimously agrees that, prior to the removal of off-board trading restrictions, the Commission should review and make appropriate changes to Commission rules (and permit comparable revisions of exchange rules) so that those who make markets on exchange floors and those who make markets in listed securities off such floors may be subject to "equal regulation" as defined in the Act. [Footnote: The definition of "equal regulation" contained in Section 3(a)(36) of the Act states "[a] class of persons or markets is subject to 'equal regulation' if no member of the class has a competitive advantage over any other member thereof resulting from a disparity in their regulation under [the Act] which the Commission determines is unfair and not necessary or appropriate in furtherance of the purposes of [the Act]."]

The Commission should also review the rules and procedures of securities information processors, such as the Consolidated Tape Association and processors providing last sale or composite quotation services, to ensure that market information is disseminated in a fair and equitable manner. Further, the Commission should recommend to the Congress that Section 11(b) of the Act be amended so as to confer upon the Commission authority to permit specialists to accept "not held" orders, if and when the Commission should find this appropriate in order to achieve equal regulation. [Footnote: How the Commission exercises such authority and what rules might be applicable to the handling of "not held" orders by specialists, if such were permitted, might be significantly influenced by the decision reached on the ability of firms to act as principal with retail customers.]

The Board also believes there is required, prior to the removal of off-board trading restrictions, further analysis and re-definition of a broker's obligation to obtain "best execution" for its customer, and also further study and specification regarding the gross and/or net reporting of transactions in the consolidated last sale reporting facility. The Board plans to examine and make recommendations with respect to these issues at its future meetings

The Board believes that, with appropriate Commission action, the review and adoption of rules of the kind discussed above, as well as the establishment of any or all of the facilities found to be necessary, can be accomplished without significant delay.

[Footnote: Throughout this letter reference is made generally to "off-board trading restrictions ." Such references apply (unless otherwise explicitly stated) to two kinds of off-board transactions by members of exchanges:

(1) Off-board principal transactions as market maker or otherwise.

(2) Off-Board agency transactions with other broker-dealers acting either as principal or agent. (Agency transactions with third market makers and nonmember block positioners have been free of restrictions since January 2, 1977.)

Our letter to the Commission, dated September 24, 1976, stated that a majority of the Board believed it would be inadvisable to remove restrictions on in-house agency crosses at that time. The letter noted, however, that such a step is closely related to the broader question of whether off-board principal transactions should be permitted, and should not be taken before the broader question is fully considered by the Commission and the Board. Many members of the Board now believe that in light of the recommended removal of off-board trading restrictions, the prohibition on in-house agency crosses should also be ended. However, some members who believe there should be a prohibition on firms dealing with their retail customers as principal, would not permit in-house agency retail crosses either.]

DISCUSSION AND ANALYSIS

A. Possible Further Fragmentation of Order Flows In Listed Securities.

One of the ways in which existing restrictions on off-board trading by member firms serve some of the purposes of the Act is by encouraging orders in listed securities to flow to exchange floors, thus increasing the opportunities for the best bids and offers to meet. However, the Board believes that opportunities for such order interaction can be maintained in other ways; that it is possible, as discussed below, to avoid most of the disadvantages of further fragmenting the order flow; and that restrictions on off-board trading can therefore be removed if the proper facilities and rules are in place prior to the removal.

1. Need for composite quotation system to avoid a reduction in the ability of the best bids to meet the best offers.

One expected result of the removal of off-board trading restrictions is increased competition in market making in listed securities, and at least a portion of such increased market making would take place in dispersed locations, including the “upstairs” offices of a number of securities firms. In addition to off-board executions by market makers, there also are likely to be off-board executions on a principal basis by broker-dealers who are not market makers but who from time-to-time deal as principal with their customers. [Footnote: Such transactions would occur with less frequency if the position of those Board members favoring a prohibition on firms dealing with their retail customers is adopted.] Without an effective composite quotation system disseminating to those about to execute transactions in diverse locations, the prices at which other persons are willing to buy and sell at the moment, there would be a reduction in the ability of the best bids to meet the best offers, and there would be an increase in the opportunities for transactions in the same security to take place at the same time in different locations at different prices. Some have suggested that the consolidated tape, existing private communications facilities, and the natural forces of competition would reduce the frequency with which sales at different prices would occur. [Footnote: Under Rule 17a-15 executions made “upstairs” by broker-dealers are required to be reported on the composite tape in a manner similar to those transactions occurring on exchanges.] However, while the tape provides information as to the prices at which transactions have occurred in the recent past , it does not provide information as to prices which might be obtained at the moment in various marketplaces. Thus the Board has concluded that, in order to reduce the likelihood that the best bids and offers will fail to meet, an effective composite quotation system must be operational before off-board trading restrictions are removed. The Board expects to consider what constitutes an effective composite quotation system and to report to the Commission its recommendations.

2. <u>The question of limit order protection in the changed environment.</u>

The likelihood that transactions in listed securities would be executed in many dispersed locations after the removal of off-board trading restrictions has led many members to be concerned about the degree to which limit orders could then be protected. Today, most limit orders are left in the “primary” market for the security and are likely to be filled if the security trades in that market in sufficient volume at the limit order price, and must be filled before the security can trade in that market <u>through</u> the limit order price. Limit orders left at other exchanges are generally protected through specialists’ “market protection” undertakings. But if a greater proportion of trading occurs at dispersed locations as a result of removing off-board trading restrictions (and particularly if broker-dealers may do in-house agency crosses or have principal trades with retail customers), then, unless further means are developed for protecting limit orders, they would be less likely to participate in transactions occurring at or through the limit order price than they are today. [Footnote: Reasons why Board members believe the protection of limit orders is an important objective of a national market system are set forth in the Board’s Limit Order Protection Letter.]

Thus many members of the Board believe that prior to the removal of off-board trading restrictions there should be in place rules or facilities which, in the new environment, would protect limit orders to the maximum extent practical in a fair and equitable manner. These members believe that while much of the detail for designing such rules and facilities might best be left to the industry, affirmative Commission action is required if the necessary facilities and rules are to be in place within a reasonable time.

Those who oppose the need for a mandated limit order protection system contend that competition would provide means of protection equal to that available today. They argue that the variety of arrangements available today will continue to be available when off-board trading restrictions have been removed and, in addition, retail firms may provide some degree of primary market or market-wide protection themselves, If such market-wide protection developed, they suggest, it could have the effect of encouraging primary market specialists to extend their own protection to transactions in other market centers, thus providing greater limit order protection than that existing today.

3. <u>The problem of having relevant interest taken into account prior to the execution of block transactions.</u>

Concern about the failure of the best bid to meet the best offer in a multiple market center environment has related primarily to the potential disadvantages to small orders. Establishment of a composite quotation system and efforts to establish additional means of protecting limit orders are directed largely towards meeting such concerns. However, a separate problem is the effect which a changed market structure will have on the extent to which relevant buying and selling interest will be reflected in block transactions.

Usually it is impractical for a potential block buyer or seller to reflect the extent of his interest in a limit order book, or display it on a quotation device, because the extent of his buying or selling interest is usually related to the price which may be paid and other factors, such as the trend of the market, at the time the transaction is executed. In addition, the disclosure of the possible size of his interest may itself affect prices significantly.

Today a buyer or seller, without having to disclose his intentions, can have the Opportunity to participate in block trades that must be brought to the floor of an exchange by stationing an agent at the trading post for a security on one or more exchanges, although few broker-dealers will be staffed sufficiently to permit this as a general practice. If off-board trading restrictions are removed, it will be possible for more large transactions to be executed in “upstairs” offices, and exchange floors are likely to be checked less frequently for undisclosed buying and selling interest once transactions have been put together. [Footnote: It is in the economic interest of a broker-dealer arranging a block transaction to execute it as soon as it has both sides. Searching out additional interest could lead to the discovery of an investor willing to displace one side, or a part thereof, at a better price, which might occasion the loss by the broker-dealer of all or part of its commission on that side of the transaction. Also, discovery of additional interest could necessitate price renegotiation which might delay the consummation of the transaction.] Thus, investors desiring to buy or sell in size who may be willing to trade at better prices will find it more difficult to have their interest considered as more block transactions are executed in private.

Although the Board sees no simple solution to this problem, it believes the benefits to the public from increased competition among specialists and market makers in listed securities outweigh this disadvantage.

B. Divergent Views Relating to Broker-Dealers Acting with Their Retail Customers as Principal.

As noted in the Conclusion, the Board is sharply divided on the question of whether concerns about further fragmentation and potential problems arising from principal dealings by firms with their retail customers require, in addition to a composite quotation system, a prohibition on such dealings in qualified securities.

[Footnote: Section 15(c)(5) of the Act gives the Commission explicit authority to adopt rules prohibiting a dealer in a security from acting as a broker in that security. Those who favor a prohibition on principal transactions with retail customers would propose that with the removal of off-board trading restrictions, the Commission exercise its authority under this section to prohibit (with appropriate exceptions) a broker-dealer from acting as principal with any of its retail customers in transactions in qualified securities, Defining "retail" for this purpose may not be easy, but these members suggest that the phrase be taken to mean "noninstitutional". In developing for this purpose an appropriate definition of "institutional", rules such as New York Stock Exchange Rule 113 and the definition of "institution" contained in the American Law Institute's proposed Federal Securities Code could be adapted.

Section 11A(a)2 of the Act gives the Commission the authority to designate by rule the securities or classes of securities to be included in the national market system and the Act refers to these as "qualified securities". The Board has considered the subject of qualified securities only briefly and expects to return to the subject shortly. Its deliberations to date suggest that different groups of securities might be deemed qualified securities for different purposes. Proponents of a prohibition on principal trading with retail customers suggest that initially the restriction might apply only to listed stocks, or perhaps only the more actively traded listed stocks. Subsequently, there might be added to this group the over-the-counter stocks which trade in similar volume to the more active listed stocks.

Since the Board's main concern is with "qualified" securities to be included in a national market system, comments or recommendations herein relate basically to such securities without any implication that any particular comment or recommendation would or would not apply to any or all non-qualified securities.]

The following is a summary of the opposing views of members.

1. <u>Reasoning of members favoring a prohibition on firms dealing with their retail customers as principal.</u> [Footnote: The discussion below is in terms of firms dealing with their own retail customers as principal. Query whether similar questions arise if firms that clear for other firms deal as principal with retail customers of their correspondents If so, the fragmentation and other problems discussed below may be intensified. If the views herein are adopted, separate consideration should be given to the clearing firm situation.]

a. <u>Reducing fragmentation</u>: As discussed above, the removal of off-board trading restrictions is likely to lead to market making in more locations, with possible adverse effects on pricing efficiency, the opportunity for the best bids and offers to meet, and the extent of limit order protection. Should the large retail firms decide to make markets in qualified securities and successfully “internalize” their retail order flow, some percentage of the public orders that now interact in exchange market places might then be executed in the offices of these firms in dealer transactions. Thus, a number of separate islands of trading would be created, and the market would become more, rather than less, fragmented than it was in 1975 when Congress mandated a national market system.

Linking these separate markets into a national market system would be far more difficult than linking the present market centers, not only because the number of markets to be linked would be greater but also because the fragmented retail order flow would present qualitatively different and more difficult problems. In particular, protection of limit orders, through whatever means, would become more difficult because limit orders needing protection would be “resting” in many more locations and would need protection in respect of trades occurring in many more markets. Almost certainly, the Board’s stated goal of achieving limit order protection “to the maximum extent practical” would have to be satisfied at a considerably lower level. [Footnote: In the over-the-counter market today, even though individual firms may accept limit orders and “protect” them in a fashion, there is no such thing as market-wide protection of limit orders. As suggested in our Limit Order Protection Letter, the absence of system-wide protection of limit orders affects not only the individual investor but the quality of the market itself.]

b. <u>Avoiding opportunities for “self-dealing” and “overreaching”</u>: Supporters of retail-trading restrictions acknowledge that in the over-the- counter market today many retail transactions take the form of principal trades, but suggest that this is not necessarily a good model for the listed market to emulate.

At least two basic functions are performed when a retail order is handled by an agent in today’s listed securities markets -- functions that may not be needed by an investor having the sophistication and bargaining power of an institution, but that are needed by the average retail investor. First, where there is active trading interest, several market centers and competing market makers for the security, the agent has the obligation, subject to consideration of relevant factors, and the ability to seek the best available market. Second, where there is more than a minimum spread between the best bid and asked, the agent may have the obligation and the skill to attempt to better the quoted price. Moreover, the execution price and commission are shown separately on the confirmation. The price is directly comparable to other prices appearing on the tape and the amount being paid for the agent's services can be compared to those charged by others for similar services. (In addition, with time stamping under the control of the market center rather than the agent itself, surveillance by self-regulatory organizations is facilitated.)

If the same order were given to a broker-dealer who executed as principal, the agency obligations mentioned in the preceding paragraph would not be as clear cut. That does not necessarily mean the customer would not fare as well as he would have had his broker-dealer acted as agent, but the customer would have greater difficulty in determining how well he was served. First, he could not directly compare the price he paid or received for the securities with what was available elsewhere in the market at the time. The customer would not normally see the entire montage of quotations and thus could not determine whether the quotations supplied by the dealer (which could be the "representative" quotations or the dealer's own quotations) were the best available. Second, he could not easily compare the transaction cost charged by his dealer -- the commission or commission equivalent -- with that charged by other broker-dealers. Some firms when dealing as principal with their customers do so on a net basis without charging any commission, some may charge a commission equivalent but an amount less than they would charge for an agency transaction, and others may charge the same amount on both agency and principal transactions. [Footnote: A separate, but related, question is how many unsophisticated investors believe they are better off with a net price simply because they do not have to pay any commission.] A comparison of the prices of two different trades for 100 shares printed on the tape at approximately the same time, by itself, would thus not provide the customer with enough information to determine how well his broker-dealer performed.

In a footnote to the Release, the Commission suggested that the prices at which principal transactions with retail customers are effected "might be required to be no less favorable than those which the firm knew or ought to have known could have been obtained for those customers if the firm had been acting in an agency capacity." [Footnote: Footnote 72 to the Release.] Supporters of the retail-trading prohibition respond that a firm should not be able to deal as principal when its price is merely "as good as" that obtainable elsewhere, because the pertinent facts are too elusive to permit either the investor himself or any self-regulator to assure that this was in fact the case. At most, such supporters concede there should be an exception for the circumstance in which a firm could show positively that it produced a better result for the customer by its own trade as principal than would have been obtainable by going anywhere else. [Footnote: Certain other exceptions to the prohibition on dealing with retail customers might also be appropriate, for example, in connection with the distribution of securities requiring the delivery of a prospectus.]

(c) Fair competition and concentration: Supporters of a prohibition point out that there are important specialist firms and third market firms that find it profitable to engage in market making apart from any retail business, so that a removal of restrictions on “upstairs” market making should enhance market making competition even if principal trades with retail customers are not permitted. On the other hand, an “upstairs” market maker having numerous retail customers with whom it could trade as principal would have an inherent advantage over other market makers because it could use its retail order flow to liquidate long or short positions and thus reduce its market making risk. [Footnote: To the extent that a firm is motivated to trade with its retail customers for the purpose of “laying off” positions assumed as a market-maker, the dangers of overreaching are aggravated.] This seems to be confirmed by the argument (of those who oppose the prohibition) that a prohibition on principal trades with retail customers would make market making much less attractive and eliminate an important incentive for integrated firms to become market makers. If so, permitting principal trades with retail customers would produce an uneven competitive balance between large integrated firms on the one hand and firms with a smaller retail order flow, or none. The ultimate result could well be further concentration of both market making and retail activities in the hands of fewer, larger firms. [Footnote: The suggested prohibition of principal trades with retail customers would not interfere in any way with the retail business of a firm electing to become an “upstairs” market maker. Such a firm could continue to handle all retail orders in any qualified security as broker, just as presently; it simply would not be permitted to switch over to principal instead of agency trades with its retail customers.]

2. Reasoning of Members Who Oppose a Retail-Trading Prohibition.

(a) Restrictions a burden on competition which unfairly advantages certain market participants: Members opposed to a prohibition on principal trading with retail customers note that a major purpose of the 1975 Amendments is to remove artificial impediments to competition. It seems anomalous to them, therefore, to see objections to firms dealing with customers as principal on grounds they can conduct business more efficiently than others and have a competitive advantage. The purpose of the Act is to foster such arrangements, not to inhibit them.

In addition, a prohibition on principal transactions with retail customers would seem to disadvantage these large retail firms unfairly. The development of large retail departments is costly, and a prohibition against integrating retail activities with the firm’s market making activities keeps the large retail firm from achieving the efficiencies of such integration and realizing the advantages of an expensive asset.

Furthermore, a prohibition on principal dealings with retail customers has the effect of institutionalizing in the market system firms that specialize solely in market making, when a free, competitive and efficient market might prove that there is no economic need for such separate service.

(b) No demonstration of actual abuses arising from possibility of overreaching which would justify such radical action -- and inherent difficulties in defining who is in need of protection: Members opposing prohibitions on principal dealings with retail customers emphasize that the practice has existed for many years in over-the-counter markets for both equity securities and corporate, municipal and government debt securities, and abuses of trust have not been found to be so common as to suggest that it should be prohibited. [Footnote: In 1935, at the direction of Congress, the Commission studied the desirability of legislation prohibiting brokers from dealing with their own customers as principal. The Commission concluded that it was not "advisable for the Congress at this time to enact legislation requiring the complete segregation of the functions of dealer and broker..." Securities and Exchange Commission, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, June 20, 1936, pages 109-110.] They note that the legal obligations of fiduciaries, competition among broker-dealers for customers, as well as the composite quotation system (NASDAQ) which allows the customer to compare the price he pays or receives to contemporaneous bids or offers, all have resulted in an over-the-counter market system which demonstrates that the existence of potential conflicts of interest does not necessarily lead to overreaching.

In addition, these members argue that there is an inherent difficulty in defining which investors need protection from potential overreaching and which do not, and that any definition of "retail customer" is likely to be arbitrary. They suggest, for example, there are some extremely sophisticated individual investors as well as some rather unsophisticated institutional investors. They also contend that the decision to include a customer in the definition "retail customer" is not necessarily an advantage to him, for once coming within the definition, the customer is barred from dealing directly with market makers and is required to pay an agent's commission, which may make his cost of investment greater than it would be if he were not included in this definition. Thus the prohibition discriminates against the retail customer and does not allow him to take advantage of cost savings which would otherwise be available to him.

(c) Apparent anomaly in desiring to protect investors in transactions involving securities with best markets but not those with less active markets, about which less information is disseminated: Opponents of the prohibition on principal trading with retail customers contend that, to the extent proposers of such restrictions are concerned about potential overreaching, it is surprising that they should single out the more actively traded securities with the most competitive markets, about which there is the greatest disclosure of transactional information.

C. <u>Creating a Fair Field of Competition Among Specialists and Market Makers After Removal of Restrictions.</u>

If the removal of off-board trading restrictions is intended to increase opportunities for competition among specialists and market makers, the Board believes it is important that the regulations applicable to such competitors create a fair field of competition.

Certain existing regulations of the Commission impose burdens on specialists on the New York and American Stock Exchanges, but on no other specialists or market makers; or on specialists generally but not on non-exchange market makers. [Footnote: See Rule 11b-1 from which exchanges other than the New York and American Stock Exchanges have been exempted, and Rule 10b-6 which makes distinctions between market makers on and off exchange floors.] In addition, the rules of each national securities exchange governing the conduct of its specialists differ from those of other exchanges, and from the rules of the National Association of Securities Dealers, Inc. which apply to non-exchange market makers entering quotations in the NASDAQ system.

As a general matter, the Board believes the Commission should not have, or require that exchanges retain, [Footnote: Section 19(b) of the Act provides that rule changes by national securities exchanges be approved by the Commission.] rules which result in different specialists or market makers in listed securities being treated differently, unless it is clear that the circumstances in which they operate are so different as to require that they have different rules applicable to them. [Footnote: This in general is the notion embodied in the Act's definition of equal regulation.] On the other hand, assuming basic rules necessary for the protection of investors are applicable in all marketplaces, it may be appropriate to allow different marketplaces to have additional, or more stringent, rules if their membership believes that would enhance the attractiveness of the marketplace to investors.

The Board believes that in connection with the removal of off-board trading restrictions, the establishment of an effective composite quotation system and the possible implementation of additional means of protecting limit orders, the Commission and the self-regulatory organizations should review existing regulations which treat various specialists and market makers differently to determine whether under the changed circumstances there should be changes in the applicable rules. The Commission should also review the rules and procedures of securities information processors such as the Consolidated Tape Association, processors providing last sale or composite quotation services, and any processor which might provide facilities for the additional protection of limit orders, in order to be sure that the rules and procedures of such organizations result in market information being disseminated in a fair and equitable manner. It has been suggested that problems in this area currently exist. For example, questions have been raised as to the fairness of requiring market center designations on the last sale tape for sales which take place other than on the New York exchanges. Also, questions have been raised about the fairness of last sale recall display devices which make it easier to recall the last sale on a New York exchange than the last sale in the system as a whole or in any other marketplace. If and to the extent problems of this kind do currently exist, the Commission should not wait for the removal of off-board trading restrictions in order to remedy them.

The Board notes that there are also rules that make distinctions between specialists and market makers which are beyond the power of the Commission to alter even if upon review such alteration seems required to create a fair field of competition, For example, the margin regulations of the Board of Governors of the Federal Reserve System give special credit advantages to “specialists”, “third market makers” and “block positioners”. Study may suggest that, with the removal of off-board trading restrictions, the definition of such categories ought to be changed. In that event, the Commission and industry should jointly make appropriate recommendations to the Federal Reserve Board. As explained at page 13 of our Limit Order Protection Letter, if certain types of limit order protection facilities are developed, the Board believes that specialists should be permitted to accept “not held” orders. This would require an amendment of Section 11(b) of the Act. Thus, the Commission should recommend to the Congress that Section 11(b) of the Act be amended so as to confer upon the Commission authority to permit specialists to accept “not held” orders, if and when the Commission should find this appropriate to achieve equal regulation.

The Board judges that these initial reviews and adjustments of rules could be accomplished within a reasonable time. Actually such review may have to be a continuing one because, as elements of a national market system, such as the means chosen to enhance limit order protection evolve, it may be necessary to change the scope and content of the rules required to ensure a fair field of competition.

The Board expects to examine during its next several meetings, some of the more important rules now applicable to specialists and market makers, including the negative obligations of New York and American Stock Exchange specialists, the affirmative obligations of such specialists, and exchange restrictions on specialists dealings with institutional customers.

D. <u>Best Execution and Gross and Net Printing</u>

Deliberations of the Board to date have suggested the need, prior to the removal of off-board trading restrictions, for further analysis and re-definition of a broker’s obligation to obtain “best execution” for its customer. With the expected increase in the number of locations where markets in listed securities are made and the establishment of new facilities, such as the composite quotation system, linking those market centers, it would appear advisable for the Commission to articulate more specifically the obligations of a broker in choosing a market in which to execute his customer's order. [Footnote: Currently a broker's obligation in this regard is defined by the general common law notion of a fiduciary's duty. However, Section 11A(c)(1)(E) of the Act gives the Commission explicit authority to prescribe rules to "assure that all exchange members, brokers, and dealers transmit and direct orders for the purchase or sale of qualified securities in a manner consistent with the establishment and operation of a national market system".] Such articulation would not only help assure that customers obtained the best price available, but would give actual and potential specialists and market makers some confidence that having the best bid or offer would, in fact, have some influence in attracting a greater order flow. In addition, a more specific definition of a broker's obligation in this regard might serve to protect brokers against customers' charges that the broker had not lived up to its obligation.

It also appears to the Board that further study and specification of gross and/or net transaction reporting is required prior to the removal of off-board trading restrictions. With more market centers of different kinds competing, the comparability of information emanating from the various market centers becomes an issue of considerable importance.

Again, this is of significance not only to ensure a fair field of competition among market centers, but also to assist investors and their agents in determining how best to execute their orders.

The Board expects to examine and make recommendations with respect to both the issues of "best execution" and gross and net printing during its subsequent meetings.

B. <u>Not Limiting Off-Board Trading To Bona Fide Two-Sided Market Making.</u>

At page 28 of the Release, the Commission states that "it may prove appropriate to permit bona fide two-sided market making off-board by exchange members prior to removing all restrictions upon off-board principal transactions by such members." As an interim step, such partial removal of off-board trading restrictions would provide some experience which the Commission might be able to use to better predict whether the composite quotation system and means chosen for the protection of limit orders would avoid most of the disadvantages of fragmentation, prior to permitting every broker-dealer to execute transactions in his own office. It would also have the effect of limiting the number of broker-dealers who could act as principal with their own customers in transactions involving listed securities and any problems of increased fragmentation or overreaching created thereby. However, such an interim step would necessitate defining "bona fide two-sided market making" and this may not be a simple task. [Footnote: For example, it may be difficult to write a rule which excludes firms whose quotations are rarely, if ever, sufficiently attractive to elicit inquiries.] Making such a distinction would also mean increased surveillance and enforcement efforts. Most important, it would continue a burden on competition by restricting the category of persons who could execute transactions off the floor of exchanges. Thus, although such a limited removal of off-board trading restrictions would have some advantages, the Board does not believe these are as great as the advantages of increased competition which would be gained by allowing all members to execute transactions off the floors of exchanges (except as to retail transactions in the mind of members favoring a prohibition as expressed above) whether or not they are bona-fide two sided market makers.

MINORITY VIEWS

Several members of the Board are of the view that the removal of off-board trading restrictions would irreparably damage the quality of the nation's markets for listed securities; that it would result in the elimination of the displacement process and a severe impairment of the pricing continuum that is the product of today's listed auction market. These members feel that the presently effective auction system would be replaced by a multi-dealer, fragmented, over-the-counter type of market; and that it is likely to reduce the membership and revenues of exchanges and thereby lead to the demise of all exchanges. These Board members argue, first, that the remaining off-board trading restrictions are not an undue burden on competition, but rather promote competition among orders and allow the execution of orders without the participation of a dealer, that they are rules of voluntary associations which persons freely join, and that these rules do not impose a competitive burden on any wider class of persons. These Board members contend that with negotiated rates which allow non-exchange members economically competitive access to exchange floors, an exchange member, by giving up its membership, can easily avoid the restrictions while retaining ease of access to the exchange. Furthermore, these members argue that to the extent these restrictions are a burden on competition they are justified by the purposes of the Act, because the high quality of the existing agency-auction markets is largely attributable to the centralized order flow of exchange members which results from the off-board trading restrictions. They conclude that to jeopardize the quality of the nation's securities markets in order to increase theoretical opportunities for competition, when vigorous competition of member principal trading already exists, is contrary to the public interest.

Other members of the Board believe that off-board trading restrictions could be removed within six months from the announcement of the Commission's determination to do so. These members believe that such a period would provide sufficient time for any other required rule changes to be considered and made, and provide adequate opportunity for the establishment of any needed facilities. They emphasize that this subject has been under discussion for a long time, that the industry already has had sufficient time to plan for the possible removal of such restrictions, and that further delay of such removal is not in the public interest.

* * * * *

The foregoing is an effort to summarize the views of the Board on off-board trading restrictions on members of national securities exchanges. As stated above, the Board believes that the purposes of the Act do not justify exchanges maintaining such restrictions generally and indefinitely. The Board recognizes, however, that the removal of these restrictions may have a profound effect on the manner in which listed securities are traded. Therefore the Board has concluded that such restrictions should be removed only after certain additional facilities and rules are in place. While there is general agreement with respect to certain facilities and the nature of certain rules which should be in place prior to the removal of restrictions there are strongly divergent views with respect to the need for other rules and facilities. Nevertheless, the Board believes that, with appropriate Commission action, the review and adoption of all rules found to be necessary, as well as the establishment of any of the facilities found to be necessary, can be accomplished without significant delay.

Respectfully submitted,

NATIONAL MARKET ADVISORY BOARD

By: John J. Scanlon, Chairman