A STAFF ANALYSIS
OF ISSUES AFFECTING THE STRUCTURE OF A
CENTRAL EXCHANGE MARKET FOR LISTED SECURITIES

-- A Discussion Paper --

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INTRODUCTION

It is generally agreed that the public and national economic interest require that the U.S. securities markets be restructured through the development of a central market system. However, the Congress, the regulatory authorities and the securities industry have been unable to agree on how such a system may best be implemented or, indeed, on how it should be structured and function. Many conflicting ideas have been advanced over the past two years; and even within the industry itself, unanimity has remained elusive.

In the absence of a unified industry-sponsored approach, it seems likely that Congress could decide to impose a system on the industry. New legislation, either with the industry's support or without it, promises to shape the future of the securities business -- and the role of the New York Stock Exchange -- at least through the end of this century, and perhaps beyond.

As the industry's principal organization -- and as the logical core of any central market system -- the New York Stock Exchange must play a decisive role in developing an approach to a central market system that can obtain the support of all concerned parties. The Board of Directors of the Exchange clearly recognizes this responsibility and has signified its determination to play a constructive role.

Recognizing the Board's intense concern, the Exchange staff has prepared this detailed discussion paper with these objectives:

a) first, to clarify the basic issues involved in implementing the concept of a central market system, and

b) subsequently, to provide a sound basis for discussions with other segments of the industry and with governmental authorities, from which it should be possible to develop a cooperative program for bringing a central market system into existence.

The staff has proceeded from the basic premise that, insofar as listed securities are concerned, a central market system must, in fact, be conceived and developed as a central exchange auction market system, and that the overriding consideration in activating such a system must be to preserve and promote exchange auction markets as the essential, indispensable pricing mechanism for listed securities.

The complexities involved in designing and implementing an effective system without disrupting the essential operation of the U.S. capital markets make it clear that a central market system cannot be created with a single dramatic gesture -- that it must be allowed to evolve through a carefully planned, logical sequence of developments. The staff envisions three distinct phases in the evolution of an effective central market system:

I.	Imminent Phase:	Establishment of a Consolidated Tape for separate marketplaces.
II.	Intermediate Phase:	Establishment of a Centralized Competing Quotation System in separate marketplaces.
III.	Final Phase:	Determination of the ultimate configuration of the Central Market System.

Following a detailed consideration of the major policy issues which must be resolved in planning the development of a central market system, this discussion paper reviews the likely characteristics and regulatory prerequisites for each of the anticipated developmental phases.

Before examining these factors, however, it may be helpful to review the positions taken on various relevant issues by the concerned Congressional committees, by the Securities and Exchange Commission, and by other securities industry organizations. Table A-1 provides a comparison, in summary form, of those positions. In addition, Table A-2 compares the positions taken by various securities industry groups on provisions of the Moss Bill (H.R. 5050) at the House Subcommittee hearings in mid-June.

Table A-1

Condensed Summary of Views
Affecting Central Market System
for NYSE Listed Securities

Issue	SEC: Policy Statement of March 29, 1973	Congressional Committees: House Subcommittee on Commerce & Finance (Moss)	Congressional Committees: Senate Subcommittee on Securities (Williams)	NYSE
Disclosure of Transactions	Single comprehensive tape (if feasible) viewed on selective, real-time basis	Full disclosure; dissemination to all "vendors"	Single comprehensive tape with neutral processor	"full disclosure of all trades executed anywhere"
Consolidated Quotation System	Develop operational system within 2 years		Develop consolidated system, but SEC should evaluate merits of all systems (including NASDAQ)	System should provide quotes to other exchanges on reciprocal basis
Market-Makers to be Included in System	Specialists, market-makers and block positioners; in addition, consider "upstairs" market-maker category	Specialists and "qualified" market-makers, subject to specialists' rules	Specialists and market-makers	Specialists only
Markets for Listed Securities Included in System and Intermarket Trading (Rule 394)	Initially trading only in listed securities to be included in system; all exchanges should rescind within 2 years rules limiting members' off-exchange trading; fourth market not included in system	Immediate elimination of Rule 394	Retention of third market; elimination of Rule 394	Absorption of third market; disclosure of all fourth market transactions; Rule 394(b) nullified only if third market is absorbed into central market system.
Market Trading Rules	Uniform rules on disclosure, short sales and prohibition of manipulative practices; NASD to be required to draft regulation for third market-makers similar to specialists' obligations	Uniformity	-	Equality and harmonization
Specialists' Contact with Institutions (Rule 113)	By Phase II, contact allowable for orders above $200,000 on experimental basis. SEC and exchanges to monitor results	Elimination once system operational	Only market-makers handling public orders; study of need to apply to all customers of those market-makers	Retention if third market is absorbed into central market system and subject to equal regulation.
Reimbursement for Exchange Seats		"Property contributions to be paid for by other members through" suitable assessments		
Access to System	Qualified broker/dealer; NYSE should consider adding Associate Membership category similar to that which exists on ASE	Equally to all broker/dealers	Those who meet certain standards of "responsibility"	
Competitive Commission Rates	Above $100,000 level by Spring, 1974	Fully negotiated in future, voluntarily or by legislation	Gradual movement to fully negotiated rates	Retention of $300,000 level -- unless Board policy statement is fully enacted
Institutional Membership	80% of brokerage with non-affiliated accounts	100% of brokerage with non-affiliated accounts. After competitive rates at $100,000 level, but no later than April, 1974	100-0% requirement for exchange membership after the last exchange eliminates all fixed commission rates or by 4/30/76, whichever is later. Two year phase-in for all members	100-0% test but 3 year phase-in after fully competitive rates for firms which were members on 10/9/72
Designated Regulatory Authority for System	Consortium of stock exchanges and NASD, with SEC oversight		NASD regulation of all retail broker/dealers; exchanges confined to regulation of own trading facilities	

Exchanges		Advisory Groups		
Regionals	SIA	SEC Advisory Committee on Market Disclosure	SEC Advisory Committee on Block Transactions	Martin Report to NYSE Board of Governors
	"full disclosure"	System run by same body that runs quote system	Same as SEC	All transactions in NYSE-listed stocks
	System should include all listed securities; dissemination should be "wide"	System should cover all listed securities; paying user should receive information on real-time basis	Same as SEC	
	Specialists and market-makers	Market-makers which can assume obligations of NYSE specialists	Same as SEC	Specialists; need for better capitalized specialists with fewer stocks
			Elimination of Rule 394	Centralized by legislation
No uniformity of specialists' capital requirements; no surrender of autonomy	Uniformity with some "permissible" variations	Equality	Uniformity	Uniformity
			Abolition of Rule 113	
				Converted into shares providing membership or floor representation
	Every qualified broker/dealer			Shareholding "members"
Opposed	Retention of $300,000 level		Block positioner must be compensated as a dealer as well as broker	No abrupt changes
	80% of brokerage with non-affiliated accounts			Prohibition or at least uniformity

Table A-2

Positions on Sections of Moss Bill (H.R. 5050), by Witnesses at House Subcommittee Hearings, June 12-15, 1973

	Securities and Exchange Commission	American Stock Exchange	Securities Industry Association	National Association of Securities Dealers	Midwest Stock Exchange	PBW Stock Exchange	National Stock Exchange
Institutional Membership	-	Yes	-	-	Yes	Yes	-
Reorganization of Self-Regulatory Bodies	-	No*	-	No	-	-	Yes*
Elimination of Fixed Rates by 2/74	No	No	No	-	Yes*	-	-
Full SEC Authority Over Self-Regulatory Rules	Yes	No	-	No	No	-	No
Full SEC Authority Over Disciplinary Actions	Yes	No	-	No	No	-	No
Rescission of Rule 394	-	-	-	-	No	-	Yes
100/0 Test	Yes	-	-	-	Yes*	No	-
Separation of Money Management and Brokerage	-	No	No	-	Yes	No	-
National Market System	Yes	Yes*	Yes	Yes	-	Yes	Yes

*Qualified position.

SUMMARY AND RECOMMENDATIONS

SUMMARY AND RECOMMENDATIONS

The central objective of preserving and strengthening exchange auction markets for listed securities -- which is crucial to the development of a viable central market system -- is inseparably related to a number of key issues which the industry has been trying to resolve. The Board of Directors of the New York Stock Exchange addressed several of these issues in a comprehensive Policy Statement issued on March 1, 1973. Among the major Exchange policy objectives identified by the Board in that statement were:

-- Ultimate elimination of fixed commission rates on all orders,* concurrently with

-- A requirement that all trades of listed securities be made on registered national securities exchanges operating under similar rules and regulations; and

-- A requirement that exchange member broker/dealers must do 100% of their business with unaffiliated public customers.

The Board called for a combined program of legislation and regulation to accomplish these objectives.**

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*It has been estimated that it might require as long as 12-18 months for member firms to develop the directives, operating manuals and computer programs necessary to implement fully competitive rates. For discussion of some of the practical problems that will be encountered in the transition of fully competitive rates, see pages 56 to 59 of this report.

**The full text of the Board's March 1, 1973 Policy Statement appears in Appendix A.

The Board hoped that these major related issues could be resolved simultaneously and thus obviate continuing controversy which might impede progress toward a central market system.

The objectives set forth in the Board's March 1 Policy Statement are designed to promote development of a new and integrated central market system. They require, however, identification and resolution of a number of additional policy issues before a central market system can move very far beyond the conceptual stages.

The principal unresolved issues, which are discussed in some detail in later sections of this paper, are summarized below. Each summary is accompanied by a brief staff recommendation, for the Board's consideration, of an appropriate position for the Exchange to adopt.

Regulation

Essentially, the central market system will be a communications system comprised of a consolidated tape and a system of competing quotations. But the mere installation of electronic gear will not assure the viability of a central market system. The most sophisticated communications network is limited by the reliability of the data that go into it. The public interest clearly demands effective rules to assure timely reporting of all pertinent price and volume information.

The public interest would best be served by adapting to the special characteristics of the central market system -- wherever

feasible -- the most effective existing trading and market-making rules and procedures, as well as the highest surveillance standards. It is imperative to avoid relying on the lowest common denominator -- that is, the standards of the most lenient regulator -- which would almost certainly impair the quality of regulation.

As a first step, the Board on June 7 authorized the staff to identify the major disparities in existing regulatory standards, in preparation for discussions between the New York Stock Exchange and other markets aimed at achieving greater uniformity of regulation.

Rule 394

Exchange Rule 394 recognizes the overriding importance of preserving auction market depth and is a significant factor in maintaining and promoting the public benefits of the exchange auction process.

Rule 394(a) prohibits member firms from by-passing the auction process and acting as market-makers in listed issues unless an issue is specifically exempted from the rule by the Exchange or specific Exchange approval is granted because of unusual circumstances.

The staff believes that Rule 394(a) should be retained and applied throughout the central market system for listed issues.

Rule 394(b) prohibits member firms from by-passing the auction process and trading in the third market without clear evidence that the third market offers the better price.

The staff believes that as long as the third market remains independent of the central exchange market system, Rule 394(b) must be retained to guard against the loss of auction market depth for reasons other than best price.

Moreover, if Rule 394(b) were abolished, without equal regulation of the third market, member firms might establish subsidiaries for the purpose of becoming dealers in listed issues -- particularly if commission rates are fully negotiated. This development would promote dealer markets to the detriment of auction markets.

Until the third market is integrated into the central market system, Rule 394(b) should be retained and applied system-wide. Once it is established that all trading of listed securities must take place within the exchange market system, the need for Rule 394(b) will be negated.

Rule 113

Exchange Rule 113 bars specialists from dealing directly with institutions in their specialty stocks. The rule was originally adopted on the recommendation of the SEC, because of the potential conflict of interest between specialists' market-making activities and their responsibilities to their own public customers.

The controversy surrounding the possible rescission of Rule 113 underscores the importance of integrating the third market into the central market system.

If the third market remains outside the system and Rule 113 remains in effect, Exchange specialists would be at a competitive

disadvantage vis-a-vis third market dealers -- with respect to institutional business -- and would have an incentive to withdraw from the central market system, thereby weakening it.

On the other hand, if Rule 113 is rescinded and the third market remains outside the central market system, specialists would be permitted to deal directly with institutions in their specialty stocks. This might be tantamount to requiring such dealings since institutions, recognizing a fiduciary obligation to obtain the best possible price for their beneficiaries, might feel constrained to deal directly with market-makers on a net basis. In turn, this would place member commission brokers at a competitive disadvantage and give them an incentive to set up their own market-making operations in listed issues. Either way, the effectiveness of the exchange auction market system would be seriously weakened. Moreover, the development of a dealer-dominated market could badly damage -- or even destroy -- the existing nationwide member firm distribution network for new securities which is the major channel through which new investment capital flows to American industry from both institutional and individual investors.

The ideal solution is to integrate the third market into the central exchange auction market system and to apply Rule 113 system-wide as a means of reassuring the public about the impartiality of all market-makers within the system.

Access

Obviously, access to any participating market within the central market system would provide access to the system itself; this should be limited to "qualified broker/dealers." Access rules must be uniform throughout the system and should be based -- to the maximum extent feasible -- on the most stringent eligibility criteria now maintained by any of the participating markets.

Regulatory Authority

An important objective of the central market system should be to streamline the self-regulatory process by minimizing the overlapping responsibilities and duplication of effort which characterize the present fragmented pattern of self-regulation. The staff believes that, in terms of effectiveness, the New York Stock Exchange has superior capability for assuming a major role in developing a system-wide self-regulatory mechanism.

Status of the Fourth Market

The fourth market -- in which institutions trade directly among themselves without any broker or dealer intermediaries -- is presently characterized by a total lack of public disclosure and public participation. With the establishment of an effective central market system, the fourth market might well expand to take over the functions now performed by the third market.

To obviate this possibility, the SEC should require effective public disclosure of direct securities transactions between and

among financial institutions. If fourth market trading does indeed increase significantly, the SEC should require that public orders be given priority and precedence in the execution of fourth market trades.

Evolution of the Central Market System

The final section of this paper discusses the prospective three-phase evolution of the central market system, beginning with the establishment of a consolidated tape, through the development of a competing quotation system, to the determination of the configuration of the ultimate central market system. From that discussion, it is clear that positions must be developed on the characteristics and regulatory prerequisites of each phase. Table B lists some of the key issues that will require careful evaluation before each of the three phases can be inaugurated.

Table B

Problems Requiring Further Study During the Three Phases of the Central Market System

Phase I

Types of uniform trading rules needed on the various exchanges

NYSE position on other unresolved issues in Consolidated Tape Plan

NYSE surveillance rules and mechanics

Clarification of brokers' obligation to obtain the "best execution" for customers

Phase II

Rules of NYSE and other exchanges to determine minimum acceptable standards for market-makers

Need for and consequences of competing market-makers on the NYSE

Uniform procedural rules for execution of orders and handling of limit orders

Phase III

Nature of ultimate corporate structure

BENEFITS OF EXCHANGE AUCTION MARKETS

Introduction

Virtually all equity trading in the U.S. currently takes place within one of two basic types of market structures: 1) stock exchanges, which embody an auction process for matching buy and sell orders; and 2) the over-the-counter market, in which the customer's broker takes his order to an informal, but organized, network of dealers in an attempt to find the best price for his transaction.

Recent discussions of the future course of the marketplace have focused a great deal of attention on the issue of the ideal structure for an efficient central market. From these discussions, the polarized concept of "auction market vs. dealer market" has emerged, implying that the central market of the future should (or will) be exclusively one or the other.

Such a dichotomy is too extreme. Each market form came into existence because of a need for the specific services it provided; each today contributes significantly to the functioning of the securities industry; and each will continue to play an important role in the marketplace of the future.

The New York Stock Exchange would be the last entity to recommend that all stocks be listed on a registered auction exchange. For many issues, volume is simply insufficient to allow auction trading on a continuous basis. For such stocks, a dealer market represents a clearly superior mechanism which must be protected.

On the other hand, for those issues in which sufficient interest exists to permit an auction mechanism, this process is the optimal method of trading. In such instances, the auction process can be shown to provide better bid-offer spreads to buyers and sellers, and hence make for a more efficient market from the point of view of the public participants.[1/]

The greatest danger to the continued existence of this dual-structure system is that in an effort to achieve efficiency through competition, the same stock will be allowed -- even encouraged -- to trade in both dealer and auction markets simultaneously. Rather than producing a situation in which the best elements of each market structure would be exhibited, this laissez-faire approach to regulation would embody the worst facets of each system. It would 1) deprive exchange auction markets of vital volume, thus weakening them immensely, and 2) divert dealers' time and capital, necessary for market-making functions in stocks of lesser volume, to issues which hardly need them. The effect of this unnecessary misallocation of resources would be a severe weakening of both markets.

Relative Benefits of Exchange Auction and Dealer Markets

Auction and dealer markets provide distinctive benefits that make each one more efficient in some cases than the other. This implies that these two types of markets should complement, rather than be competitive, with each other.

1/ Extensive statistical evidence is available to demonstrate that for auction-type stock, trading on a centralized exchange market system leads to minimum bid-offer spreads.

Relative efficiency comes down primarily to a single question: whether or not the stock is capable of maintaining a continuous auction process. If it is, then an exchange auction market is the preferred method of trading for that stock. The auction process allows a better chance for the various buying and selling interests to interact and adjust the fundamental demand/supply factors more quickly. The ability to execute trades in the auction "crowd" within the dealer's spread, without any dealer participation or intervention, makes such a market inherently more efficient in terms of cost to the public. All of this assumes, of course, that a sufficient flow of orders is forthcoming to warrant trading on exchange auction markets. By focusing on important prerequisites of the ability to maintain a continuous auction in a stock, e.g., shares outstanding and number of shareholders, exchanges' listing requirements eliminate stocks that would be too "thin" for continuous auction trading.

Inefficiencies from Fragmentation

Once stocks have been listed on an exchange, they should ideally be traded exclusively in an exchange auction market. Diversion of trades in listed issues from an exchange floor to dealer markets changes the order pattern from a relatively steady, well-balanced inflow to an unsteady or unbalanced one. The loss of activity makes it difficult for specialists to make markets in these "thin" issues; yet they are required to do so and will often need greater capital to accomplish this objective. This capital diversion from other issues hurts the marketplace as a whole.

The effect on the stockholders of the particular issue is a detrimental one, despite the availability of a "competing" market as a result of the dual trading. In a highly liquid exchange auction market, a large majority of the transactions will take place between the formal bid-offer spread quotations, through the activities of the "crowd". The "crowd" consists of brokers holding not-held orders from member firms, market orders or limit orders, which are not shown on the specialist book. As a matter of fact, the possibility of having a trade executed within the specialist's spread, means that the auction market might offer a superior execution even if a somewhat better quote in the same issue is available in a dealer market. However, as the auction thins through fragmentation, so does the "crowd", since there is no longer enough activity to warrant a continual expenditure of time at that post. This loss of well-balanced order flow tends to make the specialist's task more difficult, thereby impairing the quality of his market.

The existence of a dealer as a competitive force would not measurably improve the market in this stock, since the ability to trade <u>within</u> the spread does not exist as part of a dealer function. Moreover, the diversion of both the dealer's capital and his time to this stock results in a lessened ability to take positions in his other stocks, causing an additional detriment to the marketplace.

TWO SCENARIOS FOR THE CENTRAL SECURITIES MARKET OF THE FUTURE

Two alternative basic concepts as to the nature of the central securities market are in strong competition with each other. It is not hyperbole to predict that the selection of one or the other may determine whether the securities industry and the securities markets, as we know them today, will survive. National policy, by opting for one or the other scenario, can either preserve, indeed enhance and strengthen the exchange auction market system in the United States; or it can, regardless of the original intention, weaken -- and probably destroy -- that system and replace it with a dealer market for listed securities.

Scenario One: Preservation of Exchange Auction Markets

On March 1, 1973, the NYSE Board adopted a program designed to preserve and promote the exchange auction market and at the same time, resolve the intertwined issues of commission rates, the status of the third market, institutional membership and money management. If unresolved or addressed on a piecemeal basis, these interrelated and vexatious issues could significantly impede progress towards a central market system.

The Board's policy statement* opposed step-by-step reduction in the existing commission schedule and advocated longer-run implementation of fully competitive commission rates, provided that (1) all trades of listed securities must be made on registered national securities exchanges operating under similar rules and regulations, and

* The full text is contained in Appendix A.

(2) exchange member broker-dealers must do 100% of their business with unaffiliated public customers. The Board called for a combined program of legislation and regulation to accomplish these objectives.

The Board's program is deemed essential because, otherwise, competitive forces are likely to produce a proliferation of dealer markets leading to the weakening and potential demise of the auction market system. Such a development would have adverse consequences -- not only for the securities industry but, more important, for its customers, the investing public. Ultimately, the results could be harmful for the growth and stability of the American economy, which relies heavily on the auction process to encourage capital formation and to allocate capital efficiently with an efficient regulatory environment.

Scenario Two: Potential Destruction of Exchange Auction Markets

The second approach which has received strong support from some quarters, including the SEC and some legislators, recommends equal access for both dealers and exchanges to the central market of the future. This prescription assumes that Exchange auction markets can remain viable when dealer markets also trade in listed issues. While such an assumption was valid when commission rates were fixed, it becomes a dubious proposition in a era of competitive commissions. Those who advocate free competition between exchanges and dealer markets overlook the fact that fixed commission rates have provided a major incentive to brokers and specialists to remain members of exchanges. Failure to achieve the integration of the third market with auction

exchanges would, in an environment of competitive commissions, seriously impair the incentive to remain an exchange member. If dealers have all the advantages of exchange membership without their burdens and obligations, such as stringent and equal regulation, surveillance and capital requirements, why would brokers and specialists retain their exchange market memberships?

It is not a question of a few third market firms -- which now account for less than 6% of the volume in listed stocks[1/] -- continuing their operations at the periphery of the securities industry. The problem is that profit considerations would induce existing brokers to surrender their memberships and become third market dealers themselves. The sequence of events would be as follows:

Competitive commission rates would provide any non-member brokerage firm access to an exchange auction market whenever it needed access. Direct membership would become unnecessary. All the non-member would have to do is to negotiate some rate with a member, floor broker, or specialist. In fact, non-members might negotiate an annual retainer in return for which all their exchange transactions would be executed. The non-member firm would then have the ability to cross orders in listed issues in its back office or to block position trades in those issues without exposing them to the superior pricing mechanism of the auction markets. Dealers might have to clear up limit orders once a central market becomes a reality and to report trades on a consolidated tape. But the non-member acting as dealer would have no other obligations, at least not initially upon the advent of com-

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1/ Based on latest available data, covering the fourth quarter, 1972.

petitive commission rates. In other words, dealers would have the best of all worlds -- access to the exchange markets when they happen to need them and the privilege of trading as principals whenever that was in their best interest.

Rule 394(b) is designed to preserve the public benefits of the auction process by preventing NYSE member firms from trading in the third market unless evidence is provided that a better price is obtainable in that market. However, with fully competitive commission rates, Rule 394(b) is unlikely to survive. Since non-member dealers could move in and out of the auction market at will, members would respond competitively by insisting on the same privilege. The result would be to promote dealer markets in listed securities. Therefore, member firms which are now inclined to act as agents in executing public orders would be impelled to become market-makers or dealers in listed stocks. Some large NYSE member firms are already major dealers in over-the-counter stocks. To become major dealers in listed securities would only be an extension of their present activities.

Another way to view the critical issue of membership incentives is to recognize that member firms of the NYSE provide three services to their customers: (1) execution of orders on the floor of the Exchange; (2) clearing of orders executed on the floor of the Exchange; and (3) dealings with the public including order-taking, bookkeeping, custody of securities, research advice, and so forth. For a firm to function in the first two capacities, requires membership or, under Scenario Two, mere negotiation for access through competitive

commission rates. The third function, filling public orders, would not require membership at all. Therefore, a firm dealing with the public has no inherent reason to join an exchange.

Exchange membership is costly. Regulatory measures have been imposed on member firms to assure public confidence in the securities industry, in part by the Federal Government, and to an important extent, through the self-regulatory machinery of the NYSE. The costs of such self-regulation are significant to member firms, in terms of manpower and reports which must be filed to comply with NYSE rules and regulations.

Estimates of the cost of NYSE membership prepared by the Economist's Office show that -- for an average NYSE member firm -- direct out-of pocket costs amounted to over $140,000 in 1971 and about $96,000 in 1970. If clearance payments are excluded, the figures decline to about $60,000 and $45,000, respectively. In 1971, these figures represented about 14% of pre-tax profits on brokerage business. Direct costs amounted to 1.6% of an average member firm's gross commission revenues. In 1971, 61 firms had a profit before taxes of 1.6% or less of gross commissions. In comparison, direct costs amounted to 1.5% of an average member firm's gross commission revenue in 1970. No less than 188 firms had a pre-tax profit of 1.5% or less on gross commissions in 1970. It should be apparent that the direct costs of NYSE membership often can mean the difference between profitable and unprofitable brokerage for many firms.

Member firms of the NYSE have substantial compliance costs in addition to the various fees they pay for the operation of the Exchange. Five major diversified firms were requested to assess the

costs of compliance and surveillance. These costs ranged between 5.2% and 12.9% of total costs incurred by these firms. The average for all five firms combined was 8.3%.

Competitive commissions and the effective abolition of Rule 394(b) would not only lead to withdrawal from the exchanges by brokers dealing with the public but also by specialists. An exodus of specialists could occur for two reasons. First, specialists depend on floor brokerage for a substantial part of their income necessary to maintain a fair and orderly market. With dealer markets proliferating, that source of specialist income would dwindle. Second, specialists would shun the costs and obligations of membership when they can function equally well as upstairs dealers, with the added benefit of free choice in the selection of stocks for market-making. This development would be boosted by a composite quote system which would give market-makers more equal access to the flow of orders. It requires no elaboration to conclude that any remaining specialists on the Exchange would insist on abolition of Rule 113 which prohibits specialists from soliciting or accepting public orders in the securities in which they make markets. Since upstairs dealers would not be similarly restricted, specialists on the Exchange would demand competitive equality.

The above results under Scenario Two would not be long delayed in coming. They would occur even before the creation of a central market system. With elimination of fixed commission rates, and especially with the introduction of a system of competing quotations, upstairs market-making would come to dominate very quickly since it

would provide dealers with a competitive edge. Moreover, proposals have been advanced for legislation requiring the immediate elimination of Rule 394(b). If that legislation were enacted, member firms would be enabled to reap the advantages of transacting trades on the exchanges at the same time as they act as third market dealers. Scenario Two, therefore, is not some distant prognostication; it could materalize within the near future. The losers would be the investing public, the securities industry and all those who have a stake in optimum economic growth.

The reasons why the spread of dealer markets would produce serious adverse consequences:

1. It would lead to poor pricing. Research studies show that "best price" (i.e., narrowest spread between bids and offers) can be obtained only through centralized trading. The whole system of pricing equity assets would be distorted.
2. The public would be denied the benefits of agency representation in an auction market crowd (and this would be true even if limit orders were honored).
3. Market fragmentation would further impair liquidity.
4. There would be "disintermediation" in the sense that dealers acting as principals would eliminate the services of agents executing orders on behalf of the public.

5. The profitability of brokerage firms would fall still further, particularly among smaller and regional firms which could not compete with dealers in market-making. The securities industry would become much more sharply concentrated.

6. The network for underwriting securities in the United States would be curtailed.

The mechanism for raising capital through the issuance of equities could be weakened in two ways. At present, some major NYSE underwriters rely heavily on networks of small independent regional member firms to facilitate the distribution of new issues. However, within the context of a dealer-dominated market, those firms may not survive because they have neither the order flow nor the capital to become upstairs market-makers. Secondly, if the emergence of a dealer-dominated market reduces the liquidity of the market for listed issues, the attractiveness and the viability of raising capital through equities could be further impaired.

The net result of all these developments would be a major restructuring of the securities industry rendering the auction markets a weak facsimile of their present form, assuming that they will continue to exist at all.

* * * *

The following pages concentrate on some of the major policy questions relating to regulation, commission rates and Rules 394(b) and

113. Also discussed are the questions of access to the central market and the status of the fourth market. This is followed by a discussion of problems likely to arise in the phases necessary to implement a central market system -- from a consolidated tape to competing quotations, to a full-blown integration of markets.

DISCUSSION OF MAJOR POLICY ISSUES

REGULATION

Introduction

Within the context of the central market system, two aspects of regulation must be considered. One is the need for uniformity in rules and surveillance standards on all participating markets. The second is the need to define and establish an efficient regulatory and surveillance system to monitor compliance with those uniform rules.

Equal Rules and Surveillance Standards

As explained in the detailed discussion later in this report, inauguration of the consolidated tape and the competing quotation system will require that a wide panoply of exchange rules be equalized (except perhaps for capital requirements) on the participating markets of the central market system. For example, before the consolidated tape is fully implemented, equal rules will have to be devised on members' trading and short sales. Moreover, equal requirements will have to be established to ensure the maintenance of fair and orderly markets. Before the Phase II competing quotation system, a wide gamut of rules and standards for specialists will have to be harmonized.

As a preliminary step, on June 7, the NYSE Board of Directors voted to work with other securities industry organizations to reach agreement on equal regulations to be applied to all securities markets prior to inaugurating a consolidated ticker tape. The Board

adopted this position in the belief that it is "in the public interest that the regulatory framework for the consolidated tape be built before the investing public is exposed to this innovation. To do otherwise could be misleading and deceptive to investors."

The Board asked the Exchange staff to define precisely those areas where equal or similar rules and regulations should be applied to all markets. When completed, these areas will be discussed with other exchanges, the NASD and the SEC.

In the quest for equality of regulation, it is imperative that a Gresham's Law syndrome does not develop in which all participating markets uniformly adopt the rules and surveillance standards of the most lenient regulator. Rather, it would be in the public interest that the most effective of existing trading and market-making rules, as well as surveillance procedures and standards, be adopted by the markets participating in the central market system.

Uniform application of stringent regulatory and surveillance standards to all markets would also provide a method of eliminating the unfair competitive advantage which some markets now derive from lesser regulatory standards. In that manner, the incentive to escape the regulatory and cost burden of NYSE membership could be reduced, and the possibility of the emergence of Scenario Two could be diminished.

<u>Locus of Regulatory and Surveillance Authority</u>

An important objective of the central market system should be to streamline the self-regulatory process. Effective surveillance of compliance with equal rules established for the central market system in listed issues can be most efficiently achieved by minimizing the

overlapping responsibilities and duplication of effort involved in the present fragmented pattern of self-regulation.

In terms of effectiveness, the NYSE believes it has superior capability for assuming a major role in this effort. The Exchange has a well developed reporting and surveillance operation and a trained staff which could supply a firm foundation,where appropriate, for any industry-wide regulatory operation.

NYSE RULE 394

Introduction

In today's form, Rule 394[1/] is divided into two parts:

Part A: "Except as otherwise specifically exempted by the Exchange, members and member organizations must obtain the permission of the Exchange before effecting a transaction in a listed stock off the Exchange, either as principal or agent."

Exempt Issues: This is a list of guaranteed rail and preferred stocks which may be traded off-board without obtaining Exchange approval under Rule 394(a). Member firms trade these issues in-house, usually as market-makers. The latest list contains 176 issues of 76 listed companies.

Part B: This is a lengthy set of provisions describing the circumstances under which NYSE members may deal with the third market. In addition, supplementary material describes special situations "not in compliance with Rule 394(b)" -- i.e., when member firms may not deal with the third market.

Rule 394 has had relatively long and complicated historical development, as described in Appendix B.[2/] Briefly, the Rule:

1/ See Appendix B for the text of the Rule.

2/ Furthermore, two additional rules in the Exchange Constitution bear resemblance to Rule 394 -- namely, Rules 395 and 396 -- because they also permit off-floor transactions in securities in special circumstances. Rule 395 permits such trades in listed rights, especially for rights to purchase inactive preferred stocks and bonds listed on the Exchange. Rule 396 is the so-called "nine bond" Rule, which permits off-floor trading in listed bonds in orders of 10 bonds or more and in other circumstances. These two additional rules are mentioned here because they complement the restrictions and permissions granted under the more complex Rule 394. Thus, they could be considered as part of the complete package of rules which may have to be reviewed in the ultimate development of the central market.

1. Permits an NYSE member firm to trade listed issues within the firm itself in special legitimate cases under Rule 394(a). These include the exempt list and various categories of exceptions. A description of these exceptions, all of which require NYSE approval, is in Appendix B.
2. Permits the use of the third market by NYSE members under certain requirements covered under Rule 394(b).

Thus, while Rule 394(a) restricts off-board trades, it is essential to understand the definition of "off-board" from an administrative point of view. Off-board trades restricted by Rule 394(a) are _only_ in-house executions of listed issues, save for the exempt list and the exceptions permitted. Rule 394(a) does _not_ prevent executions on regional exchanges. Prior to the introduction of Rule 394(b), trades on the third market were not permitted (with minor exceptions) through the administration of Rule 394(a). But with the introduction of part (b), Rule 394(a) no longer has any application to the third market.

Rule 394(b) applies _only to the third market_, permitting member firms to execute listed trades there only on a restricted basis, with prior Exchange approval.

Requests for exceptions under Rule 394(a) are frequent. The extent of off-board trades in the exempt list are unknown but probably very small. Use of the third market under 394(b) is rare.

Incidentally, a great deal of confusion appears to exist over the provisions of Rule 394. For example, some individuals seem to identify all of Rule 394 with Rule 394(b).

Analysis of Rule 394

Rule 394 serves a valuable role in preserving and promoting the Exchange auction process for listed issues. As explained in an earlier section of this report, the exchange auction process is the optimal trading mechanism for issues which meet criteria of sufficient national interest (such as number of outstanding shares, aggregate market value of publicly owned shares, number of public shareholders and earnings history) to warrant listing on a national securities exchange.

The principal advantage of the exchange auction process is that, through the activities of the crowd and the priority and precedence accorded public orders, offsetting orders are matched directly. In addition, equal or better public orders supersede the specialist's bid or offer as well as prearranged trades, such as large block crosses. As a consequence, the exchange auction process provides the opportunity for trades to be executed without specialist intervention and within the specialist's spread. While data are not available on the proportion of public orders traded within the specialists' spread, a recent analysis indicates that between one-half and two-thirds of NYSE reported volume involves the matching of public orders, without the participation of specialists. Within a dealer market, this advantage is not possible. Trades are executed at the dealer's bid or offer, with the dealer participating on the other side of every trade.

However, realization of the full benefits of the auction process obviously depends upon a concentration of trading in listed issues on exchange auction markets. For example, a diversion of trading in listed stocks from exchange auction markets militates against the direct matching of offsetting public orders and reduces opportunities for public orders to receive priority and precedence in the execution of large block trades.

Rule 394(a) promotes the auction process by preventing member firms from engaging in in-house executions of listed issues unless the securities are on the exempt list or the permission of the Exchange is obtained. Rule 394(a), therefore, serves to assure that all customers' transactions in listed issues participate fully in the benefits of the exchange auction process and are subject to public disclosure.

Rule 394(b) also promotes the auction process by requiring that Exchange members provide evidence that a better price is available in the third market before they are permitted to execute a trade in a listed issue in that market.

Abolition of Rule 394(b) with the third market operating in its present form, subject to lesser regulatory standards, would provide member firms with a strong incentive to execute trades in listed issues in the third market. From the vantage point of institutions, a significant advantage of the third market is the absence of public orders emanating from the auction crowd and the specialist book, as well as the lack of a requirement to yield priority and precedence

to those public orders in executing large block trades. Thus, in the third market, a greater possibility exists that a large block trade can be executed without the intervention of public orders. However, this benefit can be at the expense of other public customers whose orders might otherwise have been satisfied at an equal or better price by participating in the large block trade.

Moreover, without Rule 394(b), if NYSE member firms could deal directly with the third market without checking the auction market, NYSE members might find market-making operations in listed issues sufficiently attractive to start their own third market operations through subsidiaries, particularly if commission rates were fully competitive. In other words, a large wire house might decide that making a market in-house is so attractive that it would establish a special subsidiary for such purposes to bypass the restrictions imposed by Rule 394(a). In view of the recent announcement by several firms of new holding company arrangements, with various types of businesses operating as separate organizations under a parent, it does not appear unreasonable to expect some member firms to add another facet to their holding company operations -- namely, a third market dealership. Therefore, as long as the third market remains subject to lesser regulatory standards, Rule 394(b) should be retained as a precaution against loss of auction market depth for reasons other than best price.

It has been argued, incidentally, that inauguration of the consolidated tape and the competing quotation system (Phase I and II of

the central market system) will eliminate the need for the "check-back" provisions of Rule 394(b), because brokers will be provided with sufficient information to determine whether a better execution can actually be obtained in the third market. However, this is not the case.

For example, last sale data disseminated by the consolidated tape will only provide historical information on trades that have actually taken place. They will not provide unequivocal evidence that subsequent executions on any particular market will actually take place at a better price.

Under Phase II, the "check-back" process required by Rule 394(b) would have less meaning than it does today, since all bids and offers on the same stock would be openly displayed. Nevertheless, the system would not eliminate <u>all</u> meaning to the "check-back" process, because an individual order of size larger than those bid for and offered by the various dealers would still require phone inquiries and/or face-to-face negotiations with specialists and other dealers as to price. If third market firms do not include a large block size indication in their quotes, member firms would not be provided with sufficient information to determine whether the third market would really yield better executions for large block orders.

Conclusions

Rule 394(a) promotes the exchange auction process as the optimal pricing mechanism for trades in listed issues by prohibiting member firms from executing in-house trades in listed issues unless the se-

curities are exempt issues or the approval of the Exchange is obtained. To assure that all investors have the opportunity to realize the benefits of having listed issues traded in exchange auction markets whenever appropriate, Rule 394(a) should be applied system-wide to the central market for listed issues.

The rationale for Rule 394(b) stems principally from the need to preserve the exchange auction process and its concomitant public benefits for individual investors in the face of unequal regulation of the third market. The absence of a requirement to yield priority and precedence to public orders in the auction crowd and on the specialist book constitutes an important incentive for executing trades in listed issues and the third market. However, the benefits third market dealers and some investors derive on this basis are at the expense of the optimal functioning of the exchange auction process and other public investors. Moreover, while some recent central market proposals would require third market dealers to yield priority and precedence to public orders on specialists' books, they would not address the need for orders in listed issues to be exposed to the auction crowd.

Moreover, if Rule 394(b) were abolished, without equal regulation of the third market, member firms might establish subsidaries for the purpose of becoming dealers in listed issues -- particularly if commission rates are fully negotiated. This development would promote dealer markets and cause a loss in auction market depth for reasons other than best price.

These considerations underscore the need for integrating all market-makers in listed issues into a central exchange auction market, subject to equal rules. Until that objective can be achieved, Rule 394(b) should be retained and applied system-wide to the central market for listed issues.

NYSE RULE 113

Introduction

At present, NYSE Rule 113 and Amex Rule 190 bar specialists on those exchanges from dealing directly with institutions in their specialty stocks (see Appendix C). No similar prohibition exists for regional exchange specialists, third market-makers or block positioners.

NYSE Rule 113 stems from a recommendation in the SEC Special Study that NYSE and Amex specialists not be permitted to deal directly with the public, because of potential conflicts of interest between specialists' market-making activities and responsibilities to their own public customers. The regional exchanges were specifically excluded from this recommendation because "[t]he specialist business on the regional exchanges is different for various reasons, including limited volume, which makes separate treatment appropriate for those exchanges."1/

Arguments for Repeal of Rule 113

At present, Rule 113 precludes NYSE specialists from effectively competing with market-makers in the third market and on the regional exchanges. Because the rule prevents NYSE specialists from dealing directly with institutions in their specialty stocks, specialists are unable to gauge accurately institutional demand and supply in those issues. This constitutes a serious impediment to the ability and willingness of NYSE specialists to quote in size and effectively compete for large block orders.

1/ Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, Part II, footnote, p. 157.

Although the Special Study felt that having institutions as customers did not help specialists make better markets in the early 1960's, the same conclusion would not necessarily be reached in today's market environment.

Under a competing quotation system without regulation equivalent to that of the NYSE, retention of Rule 113 would exacerbate this competitive disadvantage of NYSE specialists, providing them with a potent incentive to leave the Exchange and become market-makers in the third market or on regional exchanges. Retention of Rule 113 during Phase II, that is once competing quotations become available, would also diminish the possibility that specialists could arrange mergers with block-positioning houses to strengthen their competitive position in terms of capital and market-making skill.

To enable the NYSE to maintain its competitive position, and to ensure effective and equitable competition among competing specialists during Phase II, Rule 113 should either be applied uniformly to all specialists within the quote system or modified.

Arguments Against Repeal

Inauguration of a competing quotation system would reduce the possibility that any specialist unit could consistently display favoritism to its own institutional customers, even without a Rule 113. If a specialist unit did behave in that manner, it would presumably have to widen its bid-offer spreads on other orders to sustain its

profitability. In that case, the specialist could be undercut by competing market-makers not displaying favoritism towards institutional customers.

Nevertheless, opportunities for abuses stemming from a specialist's ability to deal directly with institutions may not be wholly eliminated by a system of competing specialists. In addition, another possible deleterious consequence of permitting specialists to solicit institutional orders in their speciality stocks is possible. Because of the fiduciary obligation of institutions to obtain the best possible price for their beneficiaries, institutions might feel constrained to deal directly with specialists on most trades on a net basis.

This could lead to a form of disintermediation -- the displacement of the role of brokers in institutional orders. Unless it could demonstrate convincingly the need for ancillary services provided by a broker, an institution not dealing directly with a specialist could be charged with incurring excessive transaction costs by needlessly interpositioning a broker between itself and a specialist. In that case, permitting specialists to deal directly with institutions might be tantamount to requiring it on many institutional trades.

In terms of commission costs, institutions could be provided with an unfair advantage over individuals. Institutions could deal directly with specialists on a net basis, while individuals would be required to use brokers as intermediaries and incur agency commission costs to have orders executed in listed issues.

On this basis, substantial pressure against repeal of Rule 113 would be exerted by NYSE members doing a retail and institutional brokerage business. In fact, an attempt to rescind Rule 113 several years ago was defeated by "upstairs" members. Today, specialists evidence no desire to rescind the Rule.

If Rule 113 were abrogated despite this political opposition, brokerage firms would be in competition with specialists for institutional business. To the extent that legal pressures push institutions more and more toward direct dealing with specialists, NYSE member firms may attempt to offset this competitive disadvantage and loss of business by setting up their own market-making operations in listed issues -- a kind of NYSE member "third market". This is not a farfetched idea in the face of several other possible developments:

1. Competitive rates will reduce member firm incentives to do their business on the NYSE.
2. Abrogation of Rule 394(b) will open the door for member firms to deal directly with the third market, except for a possible constraining requirement that orders on specialists' books must be satisfied first without exposure to the "crowd" -- which would deny public investors the opportunity to participate in a trade unless their limit orders were on the book.
3. The growth of holding company structures may lead to member firms establishing third market subsidiaries.

In other words, the "third market" concept as a profitable business operation may become more attractive to NYSE members to offset the increasing competitiveness of specialists without Rule 113. If member firms became market-makers, their institutional customers may find that meeting their fiduciary responsibilities may require dealing directly with these firms. The inducement to shift to in-house market-making in listed issues, especially through third market subsidiaries, would be enhanced by any lowering of profits from competitive rates, and the increased attractiveness of the third market by removal of remaining Rule 394(b) restrictions. Furthermore, establishing a separate subsidiary for third market dealer operations would enable a firm to bypass Rule 394(a), which limits strictly in-house trading.

If this chain of events leads to a dealer-dominated market in listed issues, the present NYSE member firm network for underwriting securities could be impaired or even destroyed. At present, some major NYSE underwriters rely heavily upon networks of small, independent regional member firms established to facilitate the distribution of new issues. In the context of a dealer-dominated market, these regional firms could be forced to merge or go out of business, because they have neither the order flow nor the capital to become upstairs market-makers.

Moreover, the ability of corporations to raise capital through the issuance of equities depends importantly upon the existence of liquid secondary markets. To the extent that the liquidity of the market for listed issues is reduced by the emergence of a dealer-

dominated market, the viability of raising capital through equity securities would be impaired from another vantage point.

Another argument favoring Rule 113 is the problem of "popularizing" registered stocks, now forbidden by the Rule. Without Rule 113, specialists who must continuously maintain inventories in the stock in which they are registered would have a conflict of interest problem if they were permitted to issue market letters, research reports, or other forms of favorable advertising.

Another aspect of Rule 113 involves practical business considerations. Specialists are now aware they can contact institutions without soliciting orders but few take advantage of this. Furthermore, some institutions are reluctant to disclose their interests to specialists.

Eliminating Rule 113 also may have little impact, because many institutions often choose their broker/dealers for reasons other than execution price. First, they use block houses even when the firm does not block position a particular trade, because the institution may wish to use the firm and its positioning capabilities on other more difficult trades. Firms are also selected for research. The traditional assumption is that institutions look for the best price. This is not so with respect to any single trade. Rather, they use firms which give good prices in general as well as other services.

Finally, whatever the reason for implementing Rule 113, the fact is that today member firms are accustomed to it and have structured

their business around it. To remove the rule would result in a massive restructuring of the industry with no apparent public benefit.

Conclusions and Recommendations

On the basis of this analysis, a decision on retention or repeal of Rule 113 clearly must take full cognizance of the economic consequences of either course of action.

If the third market is absorbed into the exchange system and subject to regulatory and surveillance standards equal to those of the NYSE, the competitive disadvantage to specialists of retaining Rule 113 would be significantly reduced. In that case, Rule 113 should be retained and applied system-wide to avoid the risk of displacement of the brokerage function, emergence of a dealer-dominated market, and a serious impairment, if not destruction, of the network for underwriting securities.

ACCESS

The ability to have orders executed on any of the participating markets of the central market system should be limited to "qualified broker/dealers." "Qualified broker/dealers" are defined to include those broker/dealers meeting the capital requirements and other uniform standards of eligibility defined for members of the central market system.

Since access to any participating market would provide access to the central market system, rules on access would have to be made uniform. They should be based, wherever appropriate, on the most stringent eligibility criteria in force on participating markets within the system.

Parenthetically, if the Board's March 1 policy statement is fully enacted, NYSE membership as well as access to the central market system will be available to institutions which do a bona-fide public brokerage business (i.e., 100% of brokerage with non-affiliated accounts) and meet other NYSE membership criteria.

The prohibition against handling brokerage transactions for affiliated accounts would also apply to broker/dealers that were NYSE members as of October 9, 1972, subject to a three-year phase-in after the adoption of fully competitive rates.

In addition to eliminating many of the potential conflicts of interest inherent in the combination of brokerage and money management, the 100-0% test will serve to preserve the agency/auction market by assuring investors independent representation by brokers in the purchase and sale of securities.

By Phase II, impediments to equal access among participating markets for qualified broker/dealers will have to be completely eliminated. If the third market exists in its present form during Phase II, pressure from the SEC and Congress may force the elimination or amendment of Rule 394(b). Moreover, competitive commission rates themselves will tend to generate pressures to eliminate Rule 394(b), as member firms seek to gain competitive equality with non-members able to trade on and off the Exchange. This fact underscores the importance of requiring third market dealers to be integrated into the central exchange auction market system, subject to equal rules.

Also, as previously explained, the inauguration of fully competitive commission rates will reduce the incentive of broker/dealers to retain or acquire exchange memberships. Allowing access to virtually any broker/dealer without establishing minimum qualifying standards would exacerbate the disincentives to exchange membership fostered by competitive rates. In effect, it would promote a de facto confiscation of the value of exchange seats.

To preserve the value of exchange seats, if fixed commission rates are still in effect during Phases I and II, the rate of professional discount accorded to non-member broker/dealers should be autonomously determined by each participating exchange.

FIXED VS. COMPETITIVE COMMISSIONS?

Introduction

On April 1, 1968, in response to an SEC invitation for public comments on NYSE proposals for commission rate structure modifications, the Justice Department dropped a bombshell which may well have far-reaching implications for the American securities markets. In its brief to the SEC, the Department asserted that, "The principal objective of the regulatory law, the maintaining of an effective auction market, does not appear to justify the fixing of minimum commission rates by the NYSE."

The first concession to rate competition occurred in April 1971, when the commission on the portion of an order in excess of $500,000 was made negotiable. One year later, the cutoff level was lowered to $300,000.

The SEC and others feel that the breakpoint for negotiation should be dropped to the portion of orders in excess of $100,000, which in general terms is defined as institutional size orders. Timetables, however, are a matter of contention. The SEC set April 1973 as the date for lowering the breakpoint to $200,000 and April 1974 for lowering it to $100,000. The timetable was disrupted by the industry's profit squeeze.

While there is some sentiment in favor of abandoning the limited experiment with rate competition, the principal focus of the commission debate is whether or not rate competition should eventually be extended to all orders. If it is, then the question of terms and timetable must be considered.

Why Competitive Rates

Two major threads run through the various arguments in favor of competitive rates. First, the benefits of unfettered price competition will make for a healthier and more efficient securities industry, and second, it would eliminate problems and securities industry distortions that have been an outgrowth of the historical price shelter.

Competition and Industry Efficiency

The classical model of price competition supplies the major argument in favor of competitive rates. Rewards go to the capable, while the inefficient founder and eventually disappear from the scene.

Free competition would encourage securities industry efficiencies, since each firm would try to cut costs as much as practicable to minimize its charges and attract customers away from competitors. Underlying this line of argument, of course, is the assumption that a sufficient number of firms would survive to assure that the salutary effects of competition would be realized.

Non-competitive pricing policies, it is agreed, subsidize inefficiency. In the words of the Williams Committee report, there has been "...a proliferation of grossly inefficient firms which could not serve their customers adequately and which took business away from their competitors."1/ Thus, it is contended, the normal

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1/ Securities Industry Study, Report of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, February 1973, p. 44.

winnowing process that culls out the inefficient did not take place. In addition, by affording little incentive for innovation, the lack of price competition helped precipitate the crisis of 1968-1970. Furthermore, the price umbrella permitted the flow of capital to inefficient operations. In some instances, capital infusions provided the fuel, not for achieving greater efficiency, but for an excessive expansion of the sales effort.

Because price competition was not possible, firms would compete by offering services. This led to a proliferation of services which put upward pressures on costs and, hence, the commission schedule. In other words, because of fixed rates, competition acted perversely on prices by creating pressures for commission increases rather than for reductions. Consequently, constantly rising volume is needed for the industry to break even.

Industry Distortions

If not hampered by fixed commission rates, securities trading, it has been argued, would tend to flow to a single center, because that is inherently the most efficient way to effect trades. But fixed commissions tended to fragment the markets and led to reciprocal practices and other distortions in an effort by investors to lower commission costs.

If lower commissions could not be realized on the NYSE, then why not trade elsewhere? That was the genesis of the third market. In the same vein, institutions perceived that, if they could become

exchange members, they could trade at the highly favorable member rate. With membership not available to them on the NYSE, they opted for membership on the regional exchanges, which were only too glad to accommodate them.

Between the two extremes just noted, a variety of schemes (e.g., the give-up and other reciprocal practices) sprang up. As each grew in prominence, new rules were required to maintain the integrity of the fixed commission. But almost as quickly as the web of rules was spun, new subterfuges would spring up and new loopholes to evade the rules would be found. These evasions probably could not be accomplished without the acceptance by the intended beneficiaries of fixed rates -- NYSE member firms. It is no accident that NYSE member firms account for the bulk of activity on the regional exchanges.

Thus, it has been noted that the fixed commission schedule can be evaded by the sophisticated and substantial investor. In practice, then, the fixed commission is discriminatory. Because that discrimination manifests itself in trading away from the NYSE, it fragments, weakens and distorts the entire U.S. stock trading process.

For the reasons cited, the Moss Committee report states that "...the resolution of the commission rate issue is the key to resolving most of the major questions concerning the shape of our Nation's securities markets."[2/]

2/ Securities Industry Study, Report of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, August 23, 1972, p. 132.

Ratemaking Problems

The merits of the case for fixed rates aside, it has been argued that the securities industry does not lend itself to rational ratemaking. Throughout its long history, objective standards for determining reasonableness of rates simply have not been established. Even appropriate data on which to base a rate schedule are lacking. As former SEC Chairman Casey observed, "...largely because the public utility approach to rate setting is not appropriate here, we should rely on broad judgment applied to many elements, shifting in their relative importance, rather than tending to formulate an abstract set of standards."[3/]

Even if a satisfactory basis for ratemaking could be devised, it has been asserted that the built-in time lag inherent in the rate-making process works to the detriment of the securities industry. Straight-jacketed by regulated rates, the industry does not have the flexibility to adjust rates to reflect changing conditions. Because of frequent and sharp swings in volume and revenue, it is especially crucial for the securities industry to have the flexibility afforded by unregulated rates. Lack of flexibility tends to exaggerate the effects on profits of the industry's inherent volatility.

The Case Against Competitive Rates

The major theme running through the various arguments against fully competitive rates is that the securities industry does not

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3/ Securities Industry Study, Report of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, February 1973, p. 47.

lend itself to the idealized competitive model constructed by the critics of fixed commissions. Unleashing all the forces of price competition would warp, if not completely undermine, the structure of the American securities industry, with undesirable consequences for both the capital markets and the economy at large.

Destructive Competition

The linchpin of the case against rate competition is that the inherent characteristics of the securities industry are such that open competition amongst a multiplicity of brokerage firms could not be sustained. Because economies of scale exist and because large, well-capitalized firms could afford to promote "loss-leaders," the industry would be subjected to a vigorous shakeout. In the aftermath, what would remain would be not the competitive industry envisioned by the proponents of rate competition, but an industry composed of a few giant New York-based brokerage firms. Rates would then be raised to relatively high levels, since the self-interest of the handful of survivors would lead to a tacit understanding not to compete on rates.

Weakening of the Underwriting Network

The loss of small and regional brokerage firms would cause the closing of many offices throughout the country. Since they now serve as outlets for the distribution of new underwritings, the country's traditional capital raising mechanism would be damaged. Particularly

hard hit would be smaller corporations -- the potential IBM's of the future -- whose issues are not particularly attractive to the large New York-based underwriters. Thus, impairment of the underwriting network could lead to even greater economic concentration in the business community at large. Similarly, the many thousands of local governments that depend on relatively small bond issues to finance public works would find their ability to borrow impaired.

Loss of Securities Industry Capital

During the early period of intense and even destructive competition, the industry's existing capital base would be impaired and, with the loss of profitability, brokerage firms would not be able to raise new capital. The lack of financial wherewithal to finance and improve operations would damage the industry's ability to service the U.S. economy.

Restructuring of the Stock Markets

Regardless of the public interest benefits of the exchange markets, self-interest would dictate withdrawal from membership on the NYSE and other exchanges once the economic incentive of fixed rates is lost. Exchange membership involves additional costs and regulatory burdens. With no additional compensation, good business sense would dictate dropping the costly burden of NYSE membership.

Withdrawal from Exchange membership implies a further fragmenting of the securities markets. Since fragmentation is gener-

ally accepted as being synonymous with inefficiency, it would have unfavorable consequences for securities trading.

Given the reduction in commission rates, at least initially, and the tendency toward market fragmentation, the incentive to do a dealer, rather than an agency, business would be enhanced. The replacement of the exchange markets by dealer markets would adversely affect the quality of the securities markets, resulting in higher costs to the public and greater market volatility.

Market swings would also be adversely affected, because block trades would no longer have the commission cushion. Historically, it is argued, block positioners lose money on their positions but make it up on their commissions. Loss of the commission cushion would mean block positioners would have to widen the spreads on their positions, which would add to the volatility of the stock markets.

Effect on Small Investors

Opponents of rate competition contend that its victim would be the small investor, who is so desperately needed to supply liquidity to the market. Under fixed rates, large orders help subsidize small orders, the subsidy being the price for the liquidity that small orders collectively supply. In the absence of fixed rates, the cost to small investors would rise, first, because of the loss of the subsidy and second, because the small investor

does not have the leverage of the institution. Thus, even on similar orders, institutions would obtain better rates than individuals. Furthermore, if the exchange markets were to give way to dealer markets, the individual would find it even costlier to trade because he would have to pay the dealer spread as well as the brokerage commission.

Research and Other Services

Fixed rates have provided the means to finance member firm services, especially research. Under rate competition, the emphasis would be on cost. Consequently, brokerage firms would tend to cut back or eliminate services. Where services were maintained, pressures of price competition would lead to the sacrifice of quality for economy. Particularly hurt would be small investors who, generally, need as much advice as possible.

Conclusion

Central to the argument in favor of competitive commission rates is whether the securities industry's inherent characteristics are such that a multiplicity of firms could survive in a competitive atmosphere; or are they such that only a few would survive and garner the benefits of an oligopoly at the expense of the investing public and the quality of the securities markets.

Opponents of competitive rates contend that economies of scale and the economic leverage of the larger well-capitalized firms would result in destructive competition which would reduce

the industry to a few large brokerage firms. Proponents of competitive rates agree that would be an untenable situation. However, they argue that, while the number of firms would be substantially reduced, the result would not be industry dominance by a few large firms, because the potential for economies of scale is not great. Thus, only inefficient firms would be driven out of business, with the end result being a more competitive, but healthier and more efficient securities industry.

If the destructive competition foreseen by the opponents of rate competition were realized, then the scenario of vast changes in the securities industry, described earlier, could well follow. But these opponents argue that even if their worst fears were not realized, many of the undesirable structural changes that they envision might still come about. Foremost among these would be the decline, if not demise, of the exchange auction markets, due to the lack of membership incentive and the intense pressure to trim costs and engage in more profitable activities such as market-making. Thus, the exchange system would be undermined, not because it does not serve the public interest, but because it works against the self-interest of broker/dealers in a competitive environment.

Practical Problems in Implementing Competitive Rates

If it were determined that all brokerage commissions should be set competitively, securities firms would be forced to make fundamental adjustments in their operations. The very limited

experience with negotiation on large orders offers no comparison with the difficulties that would be faced in making a transition to fully competitive rates. Thus, in setting a target date, sufficient time must be allowed for an orderly transition. A precipitate move to rate competition would, first, not allow member firms adequately to tailor the variety of service packages most suited to their special needs and the requirements of their particular clientele,and second, would throw industry paper work into turmoil.

To minimize the inevitable problems associated with an unprecedented move to full rate competition, a realistic target date must be related to a reasonable schedule for taking the various mechanical steps necessary to incorporate rate competition into the operational scheme. To fail to consider the technical and operational problems when setting a timetable for full competition could only exacerbate the effects of the inevitable structural changes resulting from competition and add unnecessarily to what will be a difficult period for the American securities industry.

A Likely Timetable

While a precise timetable should not be set without close consultation with computer and other member firm personnel familiar with operational problems, discussions with knowledgeable individuals indicate that a mid-1974 target for fully competitive rates is completely unrealistic given the preparation required.

Preliminary discussions suggest that wire houses, which are likely to have the toughest transitional problems, would require a minimum of six months to obtain and assimilate input from sales personnel throughout their branch office networks on the types of possible service packages that might be offered (e.g., execution alone, execution and research, execution and custody, etc.). Once preliminary market research is accomplished, the various possible packages must be priced out and rates determined, with possible variations for factors such as size and frequency of transactions.

After service packages and rates are set, the computer and other support required to handle the array of services must be mobilized and tested out. That includes not only extensive programming, but the preparation of manuals and other directives for both the sales branches and back office operations. Complicating the programming problem is that competitive commission rates themselves are likely to cause shifts in trading patterns, both in the period leading up to the effective date and after competitive rates are in effect. These potential shifts need to be planned for insofar as possible, and the software devised must be flexible enough to allow for changes in both the packages offered and in the rate schedules. The latter is particularly important, since under competitive rates it is expected that there would be frequent adjustments in response to changing competitive conditions.

Taking into account the period required for basic data gathering and feedback on potential service packages, it has been estimated that member firms will need 12-18 months to develop initial rate

schedules and translate them into the necessary directives, operating manuals and computer programs. On this basis, it is unrealistic to expect that an orderly transition to fully competitive rates could be achieved by mid-1974.

THE FOURTH MARKET

Introduction

The status of the fourth market within the central market system must be addressed because it could conceivably expand to fulfill the function now performed by the third market. That is, a special class of investors would be offered an opportunity to execute orders in listed securities without price and volume information revealed to the public, and without allowing the investing public to participate equally in those transactions. Thus, an unregulated fourth market exposes the central market system to the potential threat of fragmentation.

Characteristics of the Fourth Market

The fourth market offers four major advantages: (1) lower cost, (2) secrecy, (3) executions requiring one price, one ticket; and (4) the possibility of trading large blocks of stocks without significantly affecting market prices. The SEC Institutional Investor Study reported that fourth market activity "does not play a significant role in institutional trading."[1/] This finding is essentially no different from the 1963 Special Study which concluded that financial institutions used the fourth market relatively infrequently.[2/]

1/ SEC Institutional Investor Study Report, Volume 4, March 10, 1971, p. 1630.

2/ Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, Part 2, July 17, 1963, p. 844.

However, the SEC considers fourth market activity to consist only of transactions between financial institutions that arise from dealings with each other, without using a broker/dealer as intermediary. Many institutional investors and financial writers, however, regard certain broker/dealers as part of the fourth market. Typically, these broker/dealers arrange transactions in listed stocks for a flat fee that is paid on a retainer basis, rather than on a transaction basis. They are registered with the SEC as broker/dealers, or are members of the NASD, but are not registered with the SEC as third market makers.

In addition, computerized trading systems effecting listed transactions outside of a national securities exchange are also considered to be part of the fourth market. To date, the only known trading system in this category is Institutional Networks Corp. (Instinet). This NASD firm presently has 55 institutional clients. It charges a graduated percentage fee according to the value of each individual transaction, with a maximum fee of $3,750 per transaction and a minimum of $60.

The number of broker/dealers operating in the fourth market is unknown. Fourth market firms submit aggregate volume information to the SEC, but the data are included with third market volume and not broken out separately. Like third market firms, they are not required to report details on any of their transactions. The largest fourth market firm is reputed to be Donald J. Tomaso Associates, Inc. A leading financial magazine reported that this firm had 74 institutional clients, and in 1969 "served as middleman in trades amounting to $300 million."[3/]

3/ Forbes, March 1, 1970, pp. 70-7.

Potential Growth

Two schools of thought surround the potential growth of the fourth market. One holds that the fourth market is not significant enough to warrant concern. Moreover, with competitive rates, the lower cost advantage of doing business in the fourth market will shrink. Thus, the closer the industry comes to fully competitive rates, the less viable the competitive potential of the fourth market.

The opposite school of thought maintains that fourth market activity has grown since 1968, although it probably still accounts for a relatively small volume of trading. The circumstances which could lead to even greater use of the fourth market are set forth below:

1. In the absence of SEC rules requiring _all_ broker/dealers to bring _all_ orders for listed securities to the central market system, a small network of securities firms could evolve for the purpose of arranging fourth market transactions.

2. Unrestricted distribution of the central market system's bid-offer quotations would provide financial institutions with interests in the same stock with a better basis for arriving at a mutually acceptable price for direct transfer of shares.

3. New regulations requiring the disclosure of portfolio holdings would give financial institutions a better knowledge of each other's investment intentions. This would create the opportunity for financial institutions to deal with each other outside the central market system.
4. Should competing specialists concentrate on active stocks, while avoiding relatively inactive issues, no market for blocks of a certain size may exist in these issues. Under such conditions, financial institutions may have no choice but to look for the opposite side to these large blocks among their counterparts.
5. Since the central market system will entail public disclosure of all trades in listed issues, financial institutions could attempt to achieve anonymity in their trading by effecting transactions among themselves.

In addition, rules and regulations of the new central market and/or revision of the tax laws could create an environment conducive to extensive swapping of securities outside the central marketplace.

In 1967, the SEC amended the Investment Company Act (Rule 17a-7) to permit affiliated investment companies to effect transactions with each other, provided the securities were traded on a national securities exchange.[4/] No public disclosure need be made of the date or price of the transaction, although a report is made to the SEC. The result is that the investing public is unaware of transaction details, or even the aggregate number and volume of such transactions.

The number of newly formed mutual fund management companies has probably increased since 1967. However, the number of registered investment companies managed by mutual fund organizations has grown at a much faster rate. Between mid-1967 and mid-1972, nearly 400 open-end diversified mutual funds alone were created, thereby almost doubling the total in existence.[5/] The increase in the number of funds managed by mutual fund organizations has created the potential for substantial growth in direct swaps of portfolio holdings between mutual funds.

Moreover, many portfolio managers have changed jobs in recent years. Thus, portfolio managers have a much greater knowledge of how different financial organizations operate, as well as established friendships with so-called competitors. This furthers the possibility of greater direct dealings between financial institutions without a broker/dealer.

4/ Securities and Exchange Commission's 33rd Annual Report, Fiscal year ended June 30, 1967, p. 117.

5/ Vickers Directory of Investment Companies, September 1972, p. 2, and September 1967, p. 41.

Conclusions

The major undesirable effects of allowing listed securities to be transacted outside the central market system are:

1. The fragmentation of the central market system could create higher transaction costs for investors, to the extent that spreads between bid and asked prices widen.
2. Listed transactions would occur without any regard to the limit orders of individual and institutional investors.
3. Because of the potential for trading away from the central market, specialists are less likely to be willing to commit capital during temporary imbalances in supply and demand.
4. Investors who rely on price and volume movements to trigger buy and sell decisions could never be sure whether such decisions are based on complete and accurate data.

These undesirable effects create the need for rules to require public disclosure of fourth market activity, as a prerequisite to the full development of the central market system. Moreover, if fourth market volume should grow significantly, it may even be necessary to mandate that public orders be given priority and precedence in the execution of fourth market trades.

CENTAUR AND THE CENTRAL MARKET

The foundation of the central market will consist of a group of communications and data processing systems linked together so that all qualified participants can access the entire market regardless of location while achieving the reduced costs of centralized processing and record keeping.

It is not possible to precisely define the new central market systems, as many of the details are dependent on the outcome of the key policy issues. What is possible, however, is the construction of a general conceptual design of a system based on a number of assumptions on the basic capabilities required for a central market and with the knowledge that when, or to what extent, some features are to be utilized is yet to be determined.

The Securities Industry Automation Corporation (SIAC) has developed such a conceptual plan. This plan is largely based on the new automation system for the New York and American Exchanges called CENTAUR. The central market system envisioned, like the CENTAUR system, is divided into four major systems:

Communications Network
Trading Services
Market Data Services
Post Trade Services

The following sections describe, briefly, each of these four systems.

Prepared by SIAC

Communications Network

The communications system will link exchanges, member firms and institutions into a single communications network. The objective of the network is to reduce costs and improve communications efficiency by consolidating operations wherever feasible. The network approach will enable each participant to use a minimum number of lines and terminals to transmit and receive information for applications such as trade confirmations, clearing, depository, last sale and quote information, member firm and stock list communications, and others in each of their offices throughout the U.S. and abroad. In addition, improved timeliness and depth of industry information will be available to all via the network.

Trading Services System

The trading system includes that portion of the central market system starting with the entry of an order into the exchange markets, through the entire trading process, and ending with the notification to the member firm, the clearing organization and the market data system of the detailed results of the trade.

In the system all member firm communications lines between the exchanges will be connected -- either directly from their central office or, if a firm wishes, via the communications network -- to a single Central Switch that will manage the traffic for all data entering or leaving all markets. A member firm originating an order can route it through the switch to any market it desires or to the "best market" -- if policy determinations establish that requirement.

At the central switch, the system will create a file of all pending or open orders for use as the base for a specialist electronic "book." The specialist in the proposed system will have as a fundamental tool for his function an electronic terminal connected in real time to the open order file, and the market data information from all markets. This terminal will be his input and output to the system as well as his electronic book. Through it he will enter his quotations and trading data and will evaluate the market through retrieval of competitive quotations and historic trade information. Direct updating of his book from the order file will also be possible.

In the trading system the specialist plays an important part from a systems standpoint. The flow of orders in the system is a flow of supply and demand indications. Where there is perfect harmony a specialist is not required, except as an agent, to provide an open order or inventory management service. Where there is an imbalance he is indispensible. An imbalance usually results when market conditions shift and a new market equilibrium point needs to be established in a securities price. When this happens, it is important that the adjustment take place in an "orderly" fashion. That is there is not an under-dampening with the resulting excessive price oscillations or an over-dampening which would mislead the public. The trading system is thus analogous to a process control system, with the specialist acting as the fallback correction mechanism. A correction mechanism works best when it is working

at the most concentrated flow area or focal point of the process. The specialist, to function properly, must also be in that position, and the envisioned system insures that he is. When properly executing his function, the specialist's dampening effect, through buying and selling from his own account, will insure not only an orderly market but a fair market price.

In the proposed system the broker also plays a key role. He is primarily responsible for the determination of the trading strategy to be used on each order and routes it accordingly. He may want to simply electronically switch the order into the specialist's book in the case of limit orders or he may choose to electronically switch the order for automatic execution against the best bid or offer in the case of small routine market orders, and in many cases he will want to personally represent the order in the market place. The system provides improved tools to the broker for all of these activities. Greatly improved terminals to receive, display, print, or re-route incoming order traffic will be available to the broker at his station and small hand-held terminals or equivalent devices will be available to him when he enters the auction crowd. In all cases the system will insure that all key information and input such as quotations and trade details are entered into the system via electronic terminals at the exact same time as the action occurs.

Once a trade has been agreed upon as to size, price and settlement details, and the computer system has verified that the other order details from the buying and selling brokers match, the trade

will be "locked-in" -- and all details of the trade will be instantaneously transmitted to the member firms involved, to the last-sale ticker network, and to the clearing and settlement system.

The basic objective of the trading system is to reduce the cost and strengthen the auction process through the use of new automation technology. Care has been taken not to force basic change in the process simply to optimize the computer system. The new equipment will undoubtedly significantly change the physical appearance of the trading floors, but only in ways that will be consistent with maintaining the essential strengths of the auction market. Once the system is in operation, new trading patterns may evolve, but these changes, if any, will then be in response to normal competitive pressures and not to meet the requirements of the data processing system.

Market Data

The market data system combined with the communications system supports the distribution of all information concerning the market activities. The composite tape and competitive quotations will be part of this system. Improved surveillance and analysis will be another feature as a result of the availability of complete trade details such as both side identification and prevailing quotes at time of trade. It is proposed that this system be built on the recently installed MDS-II of the New York Stock Exchange, a system designed to provide a large array of services at extremely high reliability.

Post Trade/Clearance and Settlement

In this area of the central market, a national clearing system is planned that will combine trade information from all listed securities markets into a single clearing cycle. All verified trade results will be collected at a central source and netted for each firm. After member firm approval, the resulting balance will be transmitted directly to the central depository to automatically update each clearing member's inventory position.

The system will make it possible for every participating firm to have a single position per security per day and, in effect, will combine the major benefits of the delivery balance order system used by the New York and American Stock Exchanges and the continuous net system now used by other markets.

The current economic climate in the securities industry has added a new degree of urgency to the implementation of a national clearance system. While some economies will flow from the elimination of multiple clearing operations under the new system, a major incentive for change is the significant savings that each firm can attain in its internal operations as a consequence of standardizing and upgrading the clearance process. The system planned could be executed in less than one year if policy issues are resolved.

Implementation Schedule

The proposed central market system will require significant physical modifications to the existing exchanges particularly in

the trading floors. Because of the scope of these changes it is clear the system cannot be implemented in any one step or in a short period of time. What is required is a careful step-by-step implementation over a number of years. While time fram will not satisfy the bodies calling for instantaneous change, it is the only practical and workable way to effect major changes to a complex market system that must continue in full operation at all times.

The CENTAUR system for the New York and American Exchanges, which includes all of the elements of the central market system, is planned to be implemented in a series of steps starting in 1974 and completing in 1978. The expansion of the system into a full central market system could be completed in the same time frame given the resolutions of the key policy questions in the near future.

Costs and Benefits

As indicated earlier, the final system configuration is dependent on the resolution of a number of policy issues. Precise cost estimates are therefore impossible at this time. However, gross cost estimates based on a series of assumptions are in process of preparation, using the projected CENTAUR costs as a base.

The system once installed will not only produce significant improvements in investor protection, service, and visibility and timeliness of information, but will significantly reduce existing clerical and information handling costs in the member firms and exchanges.

While all benefits are not realized until full system implementation, the plan envisions that there could be sufficient cost savings to offset any increase in operating and development costs in all but the first several years. It is possible therefore, that the entire central market system could be installed for no significant increase in total costs to the industry.

Summary

The central market system proposed is a planned evolution in practical steps from the existing exchange systems, to CENTAUR for the New York and American Exchanges, and finally to the full market system. It builds on the broad experience of the major markets and places a high priority on the enhancement of the auction market. Precise system details, implementation schedules, and costs are contingent on the resolution of the key policy issues.

THREE PHASES IN THE DEVELOPMENT OF THE CENTRAL MARKET

PHASE I: CONSOLIDATED TAPE

Introduction

On March 2, representatives of the NYSE, Amex, Pacific Stock Exchange (PSE), Midwest Stock Exchange (MSE), PBW Exchange, and the NASD (representing third market firms) submitted a Plan[1] to the SEC for creation of a consolidated tape. A Consolidated Tape Association (CTA) would also be established to administer that Plan. The Plan was developed after months of discussion by a "working committee" of representatives from the participating exchanges and the NASD. Briefly, the Plan -- which is subject to the approval of the SEC -- provides as follows.

Twenty weeks after approval of the Plan by the SEC, a pilot program, lasting up to 20 weeks, will be inaugurated to identify operating and technical problems which might impede full implementation of the consolidated tape. During that pilot program, last sale prices from the PSE, MSE, PBW and third market in 15 NYSE-listed common stocks will be displayed on the NYSE tape and ticker system. At the end of the test run, the results will be analyzed to determine if any modifications to the plan are necessary before full scale operation of the consolidated tape can begin.

Characteristics

Tape and Ticker Display

The consolidated tape will transmit last sale data from participating markets over two networks. "Network A" will be the pres-

1/ "Plan Submitted Pursuant to Rule 17a-15 of the Securities and Exchange Commission Under Securities Exchange Act of 1934," March 2, 1973.

ent NYSE tape; it will also report trades in NYSE issues executed on the PSE, MSE, PBW and the third market. "Network B" will be the present Amex tape. In addition to trades in Amex issues, it will report trades in Amex issues on other participating markets and trades in issues solely listed on the participating regional exchanges.

Last sale data are defined to include for each transaction: volume (in round lots), stock symbol, and execution price. (No decision has yet been made as to the reporting of net prices.) In addition, regional and third market trades printed on the consolidated tape will be followed by an alphabetical symbol identifying the market of origin.

Eligible Securities

The plan also delineates criteria for common stocks and warrants eligible for transmission over the consolidated tape. Eligible securities are defined in terms of: number of shares publicly held; aggregate market value of publicly held shares; number of public holders; assets of the issuer and other standards. However, since these eligibility criteria are substantially below NYSE listing standards, their principal impact will be on the number of Amex and regional issues that can be reported on the consolidated tape. At a later date, eligibility criteria will be developed for preferred stocks and American Depository Receipts (ADRs).

Processor

Under the terms of the plan, the Securities Industry Automation Corporation (SIAC) will be the processor of the consolidated

tape for a period of at least five years after its full implementation. After that five-year period, the CTA will review SIAC's performance to determine whether it should continue as processor.

Hours of Operation

During the pilot program, the consolidated tape will operate during current NYSE trading hours. Prior to full implementation of the consolidated tape, representatives of the participating markets will reconsider the question of operating hours.

Prompt Disclosure

The plan mandates each of the participating regional exchanges and the third market to submit to the CTA a description of the procedures which will be used for collecting and reporting last sale data to SIAC. The collecting and reporting procedures are to be designed to permit a maximum elapsed time of one and one-half minutes between the time of execution of a trade in an NYSE issue and its reporting to SIAC. Last sale data are expected to be disseminated over the NYSE ticker within 30 seconds of receipt from other markets. Thus, the total lag between execution of regional and third market trades in NYSE issues and reporting of those trades on the NYSE tape should, in the absence of tape delays, be approximately two minutes.

Late and Out of Sequence Trades

To provide special treatment for late or out of sequence trades, the plan provides that regional and third market trades received by

SIAC more than one and one-half minutes after the time of execution will be designated as late on the consolidated tape.

Suspensions or Halts in Trading

Whenever a suspension or halt in trading occurs in a particular issue on the NYSE, because of (1) inadequate disclosure of information or (2) regulatory problems connected with that issue, no last sale information on that issue from any market will appear on the consolidated tape. However, when a suspension or halt in trading in a particular issue on any participating market results because of an imbalance of orders in that particular issue, the tape will continue to report trades in that stock from other markets.

Functions of the CTA

The CTA will be established primarily to administer the consolidated tape agreement. The plan states that the "CTA shall have the authority to develop procedures and make administrative decisions necessary to facilitate operation of the consolidated tape in accordance with the provisions of the plan and to monitor compliance therewith".2/ The CTA will not have any responsibility or authority with respect to surveillance of trading on any participating market. As at present, that responsibility will remain with each market.

2/ Consolidated Tape Plan, Section III(d).

Unresolved Issues in Phase I

The Consolidated Tape Plan leaves a variety of substantive issues unresolved. Most, if not all, of these issues have been discussed, but not resolved by the working committee of exchanges and the NASD which developed the Joint Plan. These include the need for equal trading rules on the participating markets and a clarification of brokers' obligations within the context of a consolidated tape. In addition, some operational matters need to be resolved, such as the hours of operation of the tape. Finally, the NYSE will have to determine whether the consolidated tape will require modifications of its surveillance standards and procedures.

Equal Trading Rules

On June 7, the NYSE Board agreed to work with other securities industry organizations to reach agreement on the regulations that must be equalized and applied to all participating markets before inauguration of the consolidated tape. Prior to discussions with other segments of the securities industry, the Board asked the NYSE staff to define precisely those areas where equal or similar rules and regulations should be applied to all participating markets. Pending a complete staff review, two areas in which regulation should be equalized are discussed below.

Member Trading Rules.-- Rules governing member trading have been adopted to preclude "painting of the tape"; minimize destabilizing price movements; and assure that members do not act on developments until they become public information. A consolidated tape may well negate the intent of some of these rules, if they are not applicable in other markets as well. For example, members cannot purchase substantial quantities of stock for their own account on plus or zero plus ticks. If the other markets do not have such a rule, members of this or other exchanges or the third market could make the prohibited purchase on other markets with the same impact on the tape as if it were made on the NYSE.

Rules governing member trading should, therefore, be reviewed to determine inconsistencies among the various exchanges which could facilitate evasion of rules on the primary market and undermine their intent of protecting the public against self-dealing by exchange members. In addition, participating specialists and third market dealers should be uniformly required to maintain fair and orderly markets.

Short Selling.-- Uniform regulation of short sales on all participating markets is another prerequisite to full implementation of the consolidated tape. At present, short sales are unregulated in the third market. In the absence of uniform regulation, short sales could gravitate to the market with the most lenient regulation, with potentially deleterious effects in terms of destabilizing price movements and market manipulation.

Obligations of Brokers and Specialists under the Consolidated Tape

The responsibility of brokers to their customers may need to be clarified within the context of a consolidated tape. Suppose a member firm has a limit order to execute at 71 1/2 which is the price of a block traded in the third market or on a regional exchange, while the lowest NYSE last sale is 72. What is the liability of the firm? The NYSE staff and counsel have been addressing this question.

However, the issue of brokers' obligation to obtain best execution will not be wholly resolved by securing legal protection for brokers. They will still experience severe customer relations problems whenever they do not in fact obtain the best possible price for their customers. This issue must also be addressed.

Another issue in this regard concerns orders left with brokers for execution at the opening. With competing market centers, to which market should brokers channel those orders? Moreover, what is the liability of the broker if orders disseminated to a particular market for execution at the opening are not actually executed at the best possible opening price within the system? These questions must also be resolved before the consolidated tape is implemented.

Operational Issues

During the pilot program, the Plan provides that the consolidated tape will operate during New York trading hours. The Plan also provides that before the end of the test phase, the matter of trading hours must be resolved. However, during the test phase, trades in

the 15 selected NYSE issues executed on the PSE, PBW, MSE and the third market after the NYSE close will not be displayed on the tape.

Secondly, the Plan does not provide that last sale information supplied to private vendors for inquiry or recall devices will be kept up-to-date with the Floor trading, even though the tape itself may be running late. The usefulness to member firms of more comprehensive reporting of last sale data may, therefore, be diminished during periods of tape delays.

An NYSE position on these issues must be developed before the end of the 20-week test.

NYSE Surveillance Standards and Procedures

The consolidated tape may require a revamping of some NYSE surveillance standards and practices. Although the participating markets will retain their independent regulatory and surveillance authority during Phase I, in some instances the consolidated tape will require the NYSE to take cognizance of what is happening on other markets. For example, should NYSE prices alone be considered in evaluating price stability, or should stability be measured by the run of all prices across the consolidated tape? Similarly, should the uptick rule on short sales apply to the last price on the NYSE or the consolidated tape?

Financing

To ensure equitable allocation of the costs incurred in developing and operating the consolidated tape, consideration should be given to the possibility of user financing of those costs. For example, a

charge could be levied on investors for each share in every transaction reported on the consolidated tape.

PHASE II: CENTRALIZED COMPETING QUOTATION SYSTEM

Introduction

This section provides a description of desirable attributes and regulatory prerequisites of a centralized competing quotation system. Among the topics addressed are: characteristics of bid-offer quotations; eligible securities; access to quotes and other markets; and eligibility and regulatory criteria for specialists.

The discussion is predicated on the assumption that, by Phase II, legislation will be enacted implementing the Board's proposal that all trades in listed stocks (by broker/dealers) be made on the floors of registered national securities exchanges operating under equal rules.

Nature and Types of Quotations

The competing quotation system should provide current data on the bids and offers of each competing specialist in a particular issue, as well as a designation of the name of the market center from which each quote is entered.

Bids and offers should be tendered on the same uniform basis as determined during Phase I for reporting of last sale prices over the consolidated tape. In addition, consideration should be given to requiring that each quotation should specify the number of round lots, if any, beyond a single unit of trading, for which the quote is tendered. For example, in a particular issue, the quotation of an NYSE and regional specialist might be identical, but the NYSE

specialist's quote might entail a depth of 500 shares versus 100 shares on the regional exchange. Without the size of an order on which a specialist is willing to quote, the quotation system could foster inferior executions of multiple round-lot orders. However, tendering size indications for units of more than 100 shares might have to be optional because of differences in price, volume, volatility, and risk of individual issues.

In addition to bid-offer and depth of the quote, the system might also provide data on an issue's last sale and intra-day cumulative volume and price range. This information could be retrievable by users through interrogation devices much as it is currently.

The operating hours of the competing quotation system should correspond to those established for the consolidated tape (when the tape is fully operational).

Of course, a permanent record should be kept of all quotations to facilitate stock watch and other surveillance programs during Phase II. Parenthetically, a system of competing specialists will pose extremely difficult, if not impossible, surveillance problems as discussed later in this section.

Eligible Securities

Presumably, the quotation system would disseminate quotes for the same list of securities meeting eligibility criteria established for distribution of last sale data over the consolidated tape. Since the eligibility criteria established by the Consolidated Tape Plan are below NYSE and Amex listing standards, their principal effect will be on the number of regional issues whose quotes will be reported over the consolidated quotation system.

Equal Regulation of Specialists

Capital and Performance Standards

As a prerequisite to Phase II, capital requirements, and equal trading rules, performance standards and surveillance procedures must be developed for specialists who will enter quotes into the competing quotation system.

A study of rule changes needed on each exchange to develop adequate uniform standards for the regulation of specialists during Phase II should be undertaken by a Task Force comprised of representatives of the markets that will participate in the quotation system.

At this point, however, several general guidelines can be delineated as to desirable uniform standards for specialists participating in the competing quotation system:

1. Specialists meeting the criteria for the listed issues in which they plan to specialize should be required to register as eligible specialists in the market centers in which they operate.
2. Bid-offers entered into the system must be firm for the number of shares indicated in specialists' quotations.
3. Standards must be devised to ensure that specialists effect stabilizing transactions to maintain continuous and orderly two-sided markets in the stocks in which they are registered.

4. Public orders must be given precedence (including exposure to the crowd) in the execution of large block orders.
5. A specialist must be barred from participating as a principal in any transaction in his specialty stocks, unless his bid or offer is better than any public bid or offer recorded in those stocks.
6. Registered specialists should be required to enter bona fide firm quotes and maintain continuous and orderly markets for some minimum period of time, for example, twelve months.
7. When a specialist withdraws his registration in a particular stock, he should not again be permitted to enter quotes on that stock for some minimum period of time, for example, twelve months, pending reregistration as a specialist in that stock.

Of particular importance is the establishment of minimum time periods for specialist registration in each issue. If specialists were permitted unlimited freedom of entry and exit into the system, the degree of specialist participation might fluctuate sharply from issue to issue inversely with the need for market stabilization. Under those circumstances, serious gaps could develop in the liquidity and continuity of the markets in particular issues.

Finally, if the NYSE program for requiring the integration of third market makers into an auction exchange system is rejected, the basic desirability of a system of competing quotations should be questioned. Strong doubts exist as to whether exchanges will survive if the third market offers dealers the opportunity to operate independently of exchange costs and more stringent regulatory standards while affording them equal access to the machinery of competing quotations.

Access to Quotes

All qualified broker/dealers that are members of the NYSE, Amex, and other participating markets and meet the uniform eligibility standards of the central market system, should be permitted to receive quotations from the competing quotation system.

However, since quotes of NYSE specialists are proprietary data of the Exchange, some charge should be levied on non-members to whom those quotes are disseminated. In addition, free distribution of quotes of NYSE specialists to Exchange members could provide some small additional incentive to retention of NYSE membership during Phase II.

Unresolved Issues in Phase II

A system of competing specialists poses a number of issues which must be addressed and resolved before Phase II can be inaugurated.

Accountability for Fair and Orderly Markets

For example, with competing specialists, the responsibility for maintaining a fair and orderly market would become fragmented,

and difficulties would arise in attempting to assign accountability to any one specialist. Accordingly, inefficiencies in market stabilization and self-regulation could result. To obviate this possibility, innovative surveillance techniques and performance standards will have to be developed.

Specialist Participation in Inactive Stocks

Another consequence of a competing quotation system is that it might impel specialists to demand the right to choose the stocks in which they make markets and abandon thinly-traded issues. The result could be a serious decline in the liquidity, depth and continuity in less active stocks.

Before Phase II is implemented, this potential problem should be assessed and a determination should be made as to how effective incentives can be developed to foster adequate specialist participation in inactive stocks.

Execution of Orders

A system of competing specialists poses procedural and other types of problems in the execution of orders. For example, after a broker has chosen a market for the execution of a particular order, based on best quote and most appropriate size indication, it is possible for the specialist's quote to change before that order can be executed. In that case, should the specialist be required to inform the floor broker handling the order that his quote has changed and that a better price is now being quoted on another market? Similarly, to meet his fiduciary obligation, should the broker be required to

reroute the order to the other market? Or, should the broker's fiduciary obligations be considered fulfilled once a market is chosen based on best price and size quote and the order is dispatched to that market?

To address these problems, rules will have to be devised to specify the responsibilities of broker/dealers, specialists and floor brokers in executing orders within the context of a system of competing specialists.

Limit Orders

The handling of limit orders poses additional problems. Various proposals have been advanced advocating that limit orders entered on the book of any specialist should have system-wide exposure, to assure their prompt execution whenever a trade in the same issue at the limit price occurs anywhere in the system. However, the effects of these proposals must be carefully evaluated. For example, publicizing each order prior to execution or opening the specialist book to the public, might discourage the insertion of limit orders by public investors who might be unwilling to receive the publicity, albeit anonymous, of an open book.

In addition, publicizing limit orders could generate competing orders in the same issue rather than offsetting orders on the other side of the transaction. For example, publicizing a large limit order to buy a particular stock could have the effect of creating additional interest in that stock and the insertion of additional limit orders to buy, rather than generating offsetting sell orders.

Moreover, system-wide exposure of limit orders could have adverse effects on specialists. Specialists derive an important proportion of their income from floor brokerage earned through the execution of limit orders. A redistribution of this floor brokerage income might undermine the ability or the willingness of some specialists to make markets in listed issues, particularly in inactive stocks.

Processor

Strong arguments can be advanced for assigning the processing function to the processor of the consolidated tape (SIAC). By channeling data on last sale prices and bid-offer quotations through the same organization, economies could be realized and unnecessary duplication of functions and facilities could be avoided. The NYSE, for example, already disseminates its quotations through SIAC.

PHASE III: ULTIMATE CONFIGURATION OF THE CENTRAL MARKET?

Introduction

Establishment of equal rules for all broker/dealers on participating markets and implementation of the consolidated tape and competing quotation system will represent a realization of the essence of a central market system.

After these objectives have been achieved, it is unlikely that the central market system will remain a static phenomenon. Rather, it will continue to evolve, embodying whatever refinements and modifications are deemed appropriate and desirable by the participating markets of the system. For example, Phase III will undoubtedly entail further refinements in the technology by which securities transactions are executed, settled and cleared.

However, at this point, developing a detailed blueprint for the ultimate configuration of the central market would be of limited usefulness. Phase III is simply too far across the horizon. Instead, this section provides a brief discussion of some of the issues that may need to be addressed during Phase III.

New Corporate Structure

A new corporate structure may well be desirable to ensure that the investing public pays the lowest possible cost on its securities transactions. The existence of autonomous market centers for listed securities entails numerous duplicative costs. Most brokerage houses, particularly those engaged in the retail brokerage business, are

likely to own memberships in each market center. The expenses incurred in maintaining such operations represent costs not only to individual brokerage houses, but more importantly, they are costs to the industry.

Also, because the industry's rate structure is related to total costs, the extra costs entailed by duplication of effort are ultimately borne by the investing public. Since economies of scale tend to be realized when specialized management and surveillance activities are concentrated, this goal could be achieved by combining the administrative and non-operational functions of each market center. Thus, to achieve maximum efficiency in operations, the creation of a new corporate structure involving the existing stock exchanges may ultimately be considered a logical sequel to Phase II.

The establishment of a new corporate structure of which all qualified broker/dealers in listed issues are members would also resolve the access question (if that issue has not already been resolved by the existence of fully competitive commission rates in Phase III).

Anti-Trust Protection

Another question which may need to be addressed during Phase III is whether self-regulatory activity in the central market system needs to be exempt from the antitrust laws.

At present, the 1934 Securities Exchange Act contains no express antitrust exemption for stock exchanges. Yet, the Exchange Act requires stock exchanges not only to regulate their members, but to change old rules and implement new ones as conditions warrant to protect the public interest. Moreover, the regulatory ac-

tivity of stock exchanges is subject to SEC review jurisdiction under Section 19(b) of the Exchange Act. Nevertheless, court decisions have left unclear whether or not anti-competitive claims can be made against a given rule or activity of any national securities exchange. And, considerable disagreement now exists over whether national securities exchanges need antitrust protection to perform their functions.

The question of antitrust protection is likely to become an important issue if a decision is made to adopt a new corporate structure for the central market system in Phase III. Accordingly, at that time, it may be necessary to have legal counsel study the need for antitrust immunity to permit effective operation and self-regulation of the central market system.

APPENDIX A: MARCH 1 POLICY STATEMENT OF THE NYSE BOARD OF DIRECTORS

"The Board of Directors of the New York Stock Exchange hereby adopts a comprehensive program for the improvement of the listed auction market system in order that individual investors and institutions may participate equally in all trading of listed stocks. This system is vital to the American economy in producing an efficient allocation of capital and in promoting economic growth.

"Accordingly, the Board calls for a combined program of legislation and regulation concurrently eliminating fixed commission rates on all orders and establishing the requirement that all trades of listed securities be made on registered national securities exchanges operating under similar rules and regulations.

"As a part of this entire program, and within a three-year period following its adoption, the Board of Directors calls for all members of exchanges generally to do 100 per cent of their business with the public and not to execute trades in listed securities for the account of affiliates or other institutions whose accounts they manage.

"The Board considers that this entire program as stated above should be put into effect as quickly as possible, in order that fully competitive commission rates can be in effect by mid-1974, as opposed to a step-by-step reduction of the existing commission schedule. *

"The Board, therefore, authorizes the Chairman and the staff of the Exchange to work with members of Congress, the SEC and self-regulatory organizations to develop the full details of such a program as promptly as possible."

*The Board has since announced that a mid-1974 target date for fully competitive rates is probably not feasible. It has been estimated that it might require as long as 12-18 months for member firms to develop the directives, operating manuals and computer programs necessary to implement fully competitive rates. For discussion of some of the practical problems that will be encountered in the transition of fully competitive rates, see pages 56 to 59 of this report.

APPENDIX B: NYSE RULE 394

¶ 2394 Off-Floor Transactions in Listed Stocks

Rule 394. (a) Except as otherwise specifically exempted by the Exchange, members and member organizations must obtain the permission of the Exchange before effecting a transaction in a listed stock off the Exchange, either as principal or agent.

(See Rule 371 [¶ 2371] regarding "reverse operations.")

(b) *Solicitation of Non-Member Market-Makers to Participate in Transactions Off-the-Floor of the Exchange.*

(1) A member or member organization holding a customer's round-lot order for the purchase or sale of stock may, if he so desires, solicit a qualified non-member market-maker to participate in the execution of the order for the non-member's own account, off-the-floor of the Exchange, provided he has reported to a Floor Governor, other than the specialist in the stock, that all of the following conditions have been met:

(A) A diligent effort to explore the feasibility of obtaining a satisfactory execution of the order on the floor has been made during that market session.

(B) The member or member organization has provided the Floor Governor with the following information:

(i) the name of the stock and size of the order;

(ii) details of the effort made to explore the feasibility of obtaining a satisfactory execution of the order on the Floor;

(iii) the number of shares, if any, he is taking or supplying for his own account; and

(iv) the extent, if any, of the interest the specialist has indicated in participating at an indicated price or prices.

(2) A qualified non-member market-maker in a stock is a broker-dealer registered with the Securities and Exchange Commission as a broker-dealer, who meets the capital and other applicable requirements and who has notified the Exchange that he is available to be solicited for his own account by members and member organizations pursuant to this rule for bids and offers in that stock.

(3) The member or member organization must file a report promptly after the completion of a transaction made pursuant to this rule listing all parties to the transaction; the amount of participation of each; the price; the time of receipt of the order, the time of the off-Floor execution and the name of the Governor to whom he reported.

(4) Notwithstanding the provisions of Rule 104, the specialist may buy on a plus or zero plus tick or sell on a minus or zero minus tick, any or all of the stock with respect to which a third market-maker is to be asked to participate.

(5) Under the provision of this rule, a member must ask other members in the crowd immediately prior to the off-Floor trade if they have orders to execute at the same price and on the same side of the market. If such be the case, the non-member market-maker's bid or offer may be displaced in whole or in part by:

(i) any or all bids or offers at that price on the specialist's book and any or all bids or offers made by other brokers acting as agents for other than Registered Traders, registered odd-lot dealers or members or member organizations known by the broker to be acting for their own account; or

(ii) the specialist in the stock, acting as a dealer, if the specialist before the third market-maker was solicited, advised the member or member organization of the extent of his interest at an indicated price or prices at which the transaction is to be made.

(6) No member shall effect a purchase for its customer from a market-maker if, on the basis of information supplied to the member by the market-maker, the market-maker's transaction would involve a short sale on a minus or zero minus tick based on Exchange transactions at the time of the solicitation; provided, however, that this shall not prohibit a transaction which includes a short sale of less than one round lot.

• • • ***Supplementary Material:***

.10 Situations not in compliance with Rule 394(b).—Listed below are examples of situations that would not comply with Rule 394(b). The Rule is intended only to apply to situations where member firms have solicited the participation of a qualified non-member market-maker. If, in the course of such a solicitation, the non-member market-maker asks to participate in the purchase or sale of any other security or of the same security in a different transaction, that transaction does not qualify under Rule 394(b).

(1) A member firm solicits a qualified non-member market-maker to participate in the purchase or sale of stock X. The market-maker is not interested in stock X but tells the member firm to solicit him in some other listed stock in which he does have an interest. If the member firm then solicits the market-maker in response to such request, a subsequent transaction in that other stock would not qualify under Rule 394(b). It must take place on board with a full commission charged to the non-member market-maker.

(2) A qualified non-member market-maker advises, other than by the ordinary written advertisements, notification, or publication, a particular member firm during the day that he wishes to be solicited in a given stock or stocks. The subsequent solicitation by the member firm, in response to the third market-maker's request, will disqualify the resulting transaction from qualifying under Rule 394(b).

(3) A member firm has an understanding with a qualified non-member market-maker to solicit him under Rule 394(b) whenever he has customers' orders in these stocks in which the third market-maker is qualified. Such an understanding will disqualify any transaction made pursuant to the understanding from Rule 394(b).

Any effort to accomplish indirectly that which is not directly permitted by the Rule, or the intent of the Rule as indicated in the Rule itself, and the supplementary material, will result in the transaction not qualifying under the Rule.

.20 List of guaranteed and preferred stocks exempt from Rule 394(a).—The following guaranteed and preferred stocks have been exempted from the provisions of Rule 394(a), above. However, because of the basic concept of the Exchange Constitution that all transactions in listed stocks be executed on the Floor, every proposed transaction in these securities should be reviewed in the light of the factors involved, including the market on the Floor, the price, and the size, so that whenever possible the transaction may be effected on the Floor.

(List not shown here.)

Historical Background of Rule 394

Rule 394(a)

The genesis of the Rule was Article XVI, Section 8, of the Exchange Constitution which existed in the 1930's and remained (later renumbered as Article XIV) until the Constitution was completely restructured in 1957. At that time, the Rule was renumbered as Rule 394 and reworded in its present 394(a) form.

Article XVI, Section 8 read as follows:

> "Whenever the Board of Governors by the affirmative vote of seventeen Governors, shall determine that a member or allied member is connected, either through a partner or otherwise, with another exchange or similar organization in the City of New York which permits dealings in any securities dealt in on the Exchange, or deals directly or indirectly upon such other exchange or organization, or deals publicly outside the Exchange in securities dealt in on the Exchange, such member or allied member may be suspended or expelled, as the Board may determine."

In 1940, because of concern with the activity of members on regional exchanges and an alleged lack of enforcement of this part of the Constitution, the Exchange Board adopted a resolution to prevent Exchange members from dealing in Exchange issues on regional exchanges as odd lot dealers, specialists, or in other public dealings for their own account. This led to the famous Multiple Trading Case. After Section 19(b) hearings on the question, the SEC ordered an addition to Article XVI, Section 8, permitting Exchange members to trade on regionals, thereby negating the Exchange's prior resolution.

While the Multiple Trading Case dealt only with regional exchanges, the Constitution did not distinguish regional trading from over-the-counter trades with respect to agency orders. NYSE members apparently were permitted to make agency trades on any other market, including OTC, insofar as the interpretation of the Constitution allowed. The SEC addition to Section 8, however, was confined to permitting regional trades on a principal basis only -- namely, to negate the object of the NYSE Board's resolution. Restrictions on OTC principal trades were not affected.

However, in 1948 the Department of Member Firms issued Circular No. 52 which required members to obtain Exchange approval to trade listed stock off-board, except for regional transactions. This extended Exchange restrictions to over-the-counter trades on both an agency and a principal basis, whereas former restrictions regarding OTC were on principal trades only. The motive behind the circular was an announcement by a leading over-the-counter dealer (Blyth & Co.) of its readiness to make net markets in a small number of listed stocks.

The criteria for giving a member firm approval to go off-board were never published. Permission was granted under a number of special circumstances. At first, members were even permitted to use the over-the-counter market if a customer requested it, or if the member could demonstrate that a better price was obtainable. Some codification of exceptions was achieved and, for a while, decisions in many cases as to the granting of permission were a staff function.

But this did not last long. By some form of evolutionary process, the responsibility for approving off-board trades was completely taken over by Floor officials sometimes in the early 1950's.

In 1969, the responsibility for handling requests for off-board trades under Rule 394(a) was turned over from the Department of Member Firms to the Floor Department, where it rests today. As before, the bulk of such requests continue to fall under certain categories which are generally approved by Floor officials. The more difficult decisions are made by Floor officials after the staff checks into historical precedents extending back to the period under the supervision of the Department of Member Firms. As will be shown later in this Appendix, the bulk of these cases involve off-board trades having nothing to do with the third market. Rather, they involve agency trades made within the member firm and which never appear on the tape.

Exempt List

Before 1948, Exchange member firms, usually acting as market makers, were permitted to execute off-board trades in many listed preferred stocks if approved by the Exchange. In 1948, however, the Exchange Board eliminated the prior approval requirement. A large number of member firms had been making markets in these issues. Today the exemption continues but, because of the long run decline in the importance of preferreds as an investment medium among institutions, the number of firms making markets has dwindled.

Rule 394(b)

Rule 394(b) was introduced on November 7, 1966 following a 1965 investigation by the SEC staff (as recommended by the Special Study) into the application of the Rule to that time. The SEC staff's position was that the Rule should be revised to allow member firms to execute orders in the third market when a better price is obtainable through a nonmember market-maker. They recommended net trading between members and nonmembers, but that members might be required to present the order on the Exchange Floor on the same basis as the nonmember contract. The Rule was introduced in accordance with that recommendation.

Rule 394(b) has since gone through two stages. One was a comparatively restrictive one involving considerable paperwork in the process of requiring member firms to check back with the Floor after obtaining an OTC quote. While this "checkback" process was in the spirit of the original SEC recommendation, many observers (especially nonmember market makers) claimed that it was pure red tape to discourage off-board trades. In 1967, only 398,000 shares were traded with nonmembers under the Rule. However, even though the alleged paperwork bottleneck was eased considerably in April 1970 (the second stage), the Rule continues to be rarely used. In 1971, only 274,100 shares were so traded -- less than in 1967.

Types of Off-Board Trades Permitted Under Rule 394(a)

The following is a description of the various types of exceptions permitted under Rule 394(a) requiring individual attention before permission is granted.

Control Stock

The sale of control stock is exempt from Rule 394 where the sale is by a particular seller under the requirement that an investment letter be given by the buyer. The exemption is allowed because normal procedures would not assure crossing of the sell order with the particular buyer on the Floor. Normal trading requirements, such as priority of orders, make an exemption from the Rule necessary to assure the orders being matched between the two specified customers.

Charitable Trades

On occasion, an investor may wish to make a donation to a charitable institution by selling to the institution, at his original purchase price, a security which has appreciated in price. For tax purposes, he benefits by receiving a deduction equal to the difference between the sale price and the current market, and the appreciation is not subject to the capital gains tax. In some instances, the difference between the sale price and the existing market may be substantial. Therefore, it would not be appropriate to print the sale on the tape nor give orders on the specialist book a chance at participating in the trade.

Error Trades

If a member firm commits an error by failing to execute an order in the manner or time indicated by a customer, a substantial change in the market price would make it impossible to bring the order to the Floor at the price specified by the customer. In such a case, the member firm may wish to rectify the error by trading off-board with the customer at the requested price. As a legitimate off-board trade, this is not printed on the tape.

Unsuccessful Primary and Secondary Distributions

Unsuccessful primary distributions require contact with the Floor Department and approval of a Floor Director or Senior Floor Official.

Occasionally, secondary distributions cannot be disposed of through the syndicate established to make the sale at the agreed upon arrangements. Upon request, an exception to the Rule may be granted for the syndicate to dispose of the shares remaining. The practice under the exemption is to sell the shares at a net price without commission, to permit the syndicate to sell the stock with a minimum loss.

Other

Other types of transactions are occasionally permitted, such as certain trades with foreign investors under special circumstances. These have long-standing precedents and sometimes arise because of the difference between trading hours on the Exchange and the hours of business of investors in foreign countries. Other types of off-floor trades permitted under Rule 394(a) are corporate reacquisitions.

APPENDIX C: NYSE RULE 113 AND AMEX RULE 190

¶ 2113 Specialists' Public Customers

Rule 113. (a) No specialist, his member organization or corporate subsidiary of such organization within the meaning of Rule 322, shall accept an order for the purchase or sale of any stock in which he is registered as a specialist directly (1) from the company issuing such stock; (2) from any officer, director or 10% stockholder of that company; (3) from any pension or profit-sharing fund; (4) from any institution, such as a bank, trust company, insurance company, or investment company.

(b) No order given to a specialist for the purchase or sale of a security in which he is registered as a specialist shall indicate in any way the account for which it is entered except for orders for accounts in which the below-named persons or parties have a direct or indirect interest:

(i) The specialist himself;

(ii) any member, allied member, officer, employee or person or party active in the business of such specialist;

(iii) the spouse and children of any of the above-named persons or parties who reside in the same household as such person or party; and

(iv) any approved person, limited partner, or party approved pursuant to Section 7 (g) of Article IX of the Constitution belonging to the same member organization as such specialist.

(c) Every specialist shall report to the Exchange such information as the Exchange may require with respect to transactions made in the stocks in which he is registered for any customer account not prohibited under section (a) which:

(1) is carried by his member organization; or
(2) is serviced by him or his member organization; or
(3) is introduced by him or his member organization to another member organization on a disclosed basis.

Amendments.
September 16 and 17, 1964, effective January 4, 1965.
May 18, 1972.

• • • ***Supplementary Material:***

.10 **Form SPA.**—In accordance with the above rule, specialists are required to submit weekly reports on Form SPA. This form can be obtained at the Information Desk on the Floor.

.20 "Popularizing" specialty stocks.—It is contrary to good business practice for a specialist or his member organization or any other member, allied member, approved person, limited partner or a party approved pursuant to Section 7 (g) of Article IX of the Constitution in such organization or any officer or employee thereof to "popularize", either orally or in writing, any security in which he is registered.

Amendments.
May 18, 1972.

ASE Rule 190

Par. 9330, Rule 190, Part A.

No specialist shall, directly or indirectly, effect any business transaction with a company or any officer, director or 10% stockholder of a company in whose stock he is registered as a specialist.

Par. 9330, Rule 190, Part B.

No specialist shall accept an order from insiders or from any institution.

Par. 9330, Rule 190, Part D.

Any specialist who introduces any account to a member must report this information and a statement as to whether he has any direct or indirect financial interest in such account.

Par. 9330, Rule 190, Commentary.

"It is contrary to good business practice for a specialist or his member firm or member corporation or any member or employee thereof to make public statements, oral or written, for the purpose of encouraging or discouraging the purchase or sale of any security in which such specialist is registered."