TESTIMONY ON THREE PROPOSED SEC RULES AND ON THE MARKET RESPONSIBILITY RULE

My name is Walter N. Frank. I am a Partner of Walter N. Frank & Co., members of the New York Stock Exchange, Inc., and presently a Director of the Exchange. My remarks today cover two related matters. First, our comments on the three rules proposed by the Commission in its release of September 2; and second, an explanation of the New York Stock Exchange's proposed new "Market Responsibility Rule."

We have prepared a detailed analysis of the three proposed rules which I would like to offer for the hearing record. My remarks will summarize some of the major comments included in this paper on the three rules, which for convenience I will refer to as the "A", "B" and "C" rules.

There are two major problems which are common to all three proposed SEC rules. As drafted, all three may apply to trades on other national securities exchanges as well as to trades in the over-the-counter market. If applied to other exchanges, the rule would be more restrictive than is the current practice under exchange rules. Nothing in NYSE Rule 394 today limits or restricts a member's ability to trade either as principal or agent on another national securities exchange.

The second problem common to the three proposed rules is that they apply only to exchange members and member organizations. They do not apply to broker-dealer affiliates, including parents or subsidiaries, of a member organization. In order to accomplish the intended objectives of any rule imposing an obligation on members to the auction market, it seems clear that the rule must apply to securities brokers and dealers affiliated with the member as well as to the member itself. Otherwise, it would be easy for any member organization to avoid the rule whenever it wishes to do so.

Apart from these two common problems, each of the three rules takes a different approach. If the "A" rule is adopted, all existing rules of the NYSE prohibiting or limiting in any fashion the ability of any member to trade off the Exchange will be rescinded. Members would be free to execute transactions in NYSE stocks, either as principal or agent (or perhaps only as agent) in any other market, without any restriction or obligation to the exchange markets whatsoever.

The result would be immediate and far-reaching for investors and the securities industry. There would be, in my opinion, less effective competition, larger spreads in quotes, and much less depth and liquidity in markets.

If the "A" rule is limited to agency transactions, the exchanges could continue to restrict dealer transactions by members off an exchange. Even so, agency orders could be executed over-the-counter without satisfying public bids or offers on an exchange, therefore excluding the participation of public investors.

In summary, we feel that the adoption of either alternative form of the "A" rule would not be in the public interest, and would not meet the primary objectives of the Securities Act Amendments of 1975.

Both the "B" rule and the "C" rule would require the satisfaction of certain orders on the Floor of an exchange, before a trade could be executed over-the-counter, a concept which the NYSE supports. Basically, the "B" rule would require the satisfaction of public limited orders on the specialist book at better prices, while the "C" rule would require the satisfaction of all public orders at the same price or better, plus the satisfaction of bids or offers made by the specialist or other members for their own accounts at better prices.

Both rules, as drafted, would permit principal trades by members and member organizations off the Floor under the same conditions as agency trades. Thus, members could make dealer markets upstairs and public investors could be effectively excluded from participating in such trades.

Secondly, while both rules adopt the concept of an initial inquiry, and a responsibility to satisfy certain orders present at the time of the initial inquiry, neither version adequately defines the required inquiry. For example, neither version requires that the inquiry take place immediately prior to the off-Floor execution. If any significant period of time is allowed to elapse between the required inquiry which identifies the only orders on the Floor which have to be satisfied and the later point at which such orders are satisfied, the rule becomes meaningless. Surely no off-Floor trading rule should permit the inquiry to be made in the morning and the off-Floor execution to take place that afternoon or the next day, perhaps after a major market fluctuation.

A second difficulty with the "inquiry" required by the "B" and "C" rules has to do with the nature of the inquiry. Clearly, the "B" rule -- and possibly paragraph (1) of the "C" rule -- permits the required inquiry to be made simply by interrogating an electronic device displaying bid-asked quotations. While problems exist with keeping quotations up to date, especially in busy markets, a more basic problem is that the quotation machines only supply the current quotation being made by the specialist. If, as often is the case, there are brokers in the Crowd willing to buy or sell and trying to do the best brokerage job possible for their customers, the specialist's quotation may not reflect the extent of that interest. Only a direct inquiry of the Crowd at the Post will reveal this interest.

In addition, any dealer may be willing to improve his bid or his offer. It is unrealistic to believe that the quotation published from moment to moment by any dealer is always the best he is willing to consider under any circumstances.

Finally, both the "B" and "C" rules require only such inquiry as the member in the exercise of his professional judgment deems appropriate under the circumstances. It may well be that under the circumstances, the member may decide that no inquiry at all of the exchange is appropriate. In that event, he would be free to trade off-Floor with no obligation to the exchange market at all.

Both rules also raise problems as to the price of the off-Floor transaction. Neither rule recognizes that the off-Floor execution of the entire order may be at two or more different prices. Consequently, it is not at all clear which price of the off-Floor transaction controls for purposes of these rules. Is it the price of the first portion of the order executed off the Floor, regardless of the price of the balance of the execution? For example, if the market on the Exchange is 50 to 50 1/4, and an over-the-counter dealer has told a member that he will buy 100 shares at 49 3/4, and 9,900 shares at 49, it is not clear that the bids on the Exchange below 49 3/4 have to be satisfied.

There are at least three other problems raised by the “B” rule. The first is that by allowing trades to be effected on an exchange, without providing for the participation of the specialist, it would eliminate the affirmative obligation of the specialist to maintain fair and orderly markets. Thus, under the “B” rule, the specialist might be forced to allow successive transactions at 50, 49 5/8, 49 3/8 and 48 7/8, since he would be unable to interject bids in order to prevent successive transactions from occurring at such wide variations. This concept would also presumably repeal any specialist obligation the after-market, since he would be unable to position himself during the preceding transactions.

Secondly, the “B” rule does not require that bids or offers, made on behalf of public orders, at the same price as the proposed off-Floor transaction price, be filled at all. Thus, if the off-Floor transaction was with a broker-dealer, that broker-dealer would have the advantage over public orders on the exchange. This is a concept that we find particularly objectionable.

Thirdly, under the “B” rule, public orders are filled at the prices at which they are bid or offered, rather than at the off-Floor transaction price. Rules similar to NYSE Rule 127 are designed to attempt to give such public orders the benefit of the “clean-up” price, but the “B” rule would preclude this.

The “C” rule solves these last three problems. Under the “C” rule, the specialist and other members dealing for their own account would participate in the transaction, provided their bids or offers were at prices better than the proposed off-Floor transaction price; public orders at the same or better prices than the proposed off-Floor transaction price are required to be satisfied also; and these public orders are filled at the off-Floor transaction price, if the exchange has a rule approved by the Commission providing for this.

The “C” rule however, does not solve other problems inherent in both the “B” and “C” rules: namely, the permissibility of principal trades; the timing problem between the inquiry and satisfying Floor orders; confusion as to the “transaction price”; and the imposition of very little responsibility of the member to the exchange market. Further, as drafted, neither proposal deals with either the dual member problem or the affiliated broker-dealer problem.

For all these reasons, and additional problems noted in the Exchange’s written analysis of the three SEC-proposed rules, the Exchange cannot support the rules as drafted. We earnestly believe that the adoption of any of the rules by the Commission would be contrary to the public interest and would retard, not advance, the national market system envisioned by the Securities Acts Amendments of 1975.

We have, however, given a great deal of thought to the subject of off-board trading rules. As a result, the Ad Hoc Committee on Rule 394 has recommended to the Board of Directors of the Exchange, and the Board at its meeting last week adopted (in principal?), a new Market Responsibility Rule, to replace present Rule 394. We believe the proposed new NYSE rule, which will be filed shortly with the Commission under Section 19(b) of the 1934 Act, avoids the problems we find in the Commission's proposals. Let me summarize it for you briefly.

The new Market Responsibility Rule allows member organizations to execute transactions over-the-counter with non-member brokers and dealers. It eliminates any concept of "initial inquiry." It permits the member to inquire wherever he chooses. To safeguard public customers from being bypassed and to insure that the executing broker obtains the best price available, the rule requires that immediately before an over-the-counter transaction is to be made, all public orders on the Exchange at prices at least as good as the price of the over-the-counter transaction be filled, and all orders on the Exchange for professionals at better prices be satisfied.

The main thrust of the rule is to protect the public customer and to provide the public customer with benefits which would not otherwise be available. Only in the auction market does the public investor have the opportunity, and in a great many cases the likelihood, of meeting a public order on the other side of the transaction, with improved results for both participants, buyer and seller.

Thus, this proposed Market Responsibility Rule simplifies the procedures in effect under the present Rule 394, satisfies the serious objections we have to the three rules proposed by the Commission, and strengthens the basic concept of permitting the public and competing dealers to participate in the trading of listed stocks.

We have also proposed revisions in the Commission's "C" rule to parallel the Exchange's proposed Market Responsibility Rule. We are confident that our suggested revision of the "C" rule speaks to the problems we have identified. We are submitting it herewith for the Commission's consideration, even though we strongly urge the Commission to approve the Market Responsibility Rule.