NATIONAL MARKET ADVISORY BOARD

September 6, 1977

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

Re: Regulation of Specialists and Market Makers in Light of the Proposed Removal of Off-Board Trading Restrictions

Dear Sirs:

In our letter to you of May 19, 1977 with respect to off-board trading by members of national securities exchanges, the Board stated its unanimous view that, prior to the removal of off-board trading restrictions, there should be a review of statutory and regulatory requirements applicable to specialists and market

makers in listed securities to insure that they would be subject to “equal regulation” after such removal.

In the letter the Board also noted that it expected to examine in more detail some of the more important rules applicable to specialists and market makers. The following is a report on that examination.

1. Basic Principles

In considering changes in rules affecting specialists and other market makers that should be made in connection with the lifting of restrictions on upstairs market making, the Board believes the following principles should govern”

a. “Equal regulation” is a major objective, but this does not mean identical regulation. The statute contemplates that differences in circumstances among competitors should be taken into account in considering what regulatory disparities are or are not appropriate. The aim should be to bring competitors into a “fair field of competition” and avoid artificial or unfair incentives or disincentives to various types of market making.

b. It should not be assumed that all problems that have required regulation in the past will be solved by the introduction of competition, let alone the mere possibility of competition. For example, rules designed to prevent manipulation or overreaching, or to assure fair and orderly markets should not necessarily be changed, and may need to be extended to other markets to achieve “equal” regulation, even when there is a more competitive market system.

c. On the other hand, a rule existing in one market should not be perpetuated, let alone extended to another, without considering whether there is a need for the rule anywhere in a competitive market system. Thus, any rules that was essentially needed to control or counteract a monopoly situation of any kind should not be perpetuated, let alone extended, if, as and when the circumstances creating the monopoly situation no longer exist.

d. The requirements of due process mean that rule changes in these important and complex areas take time. Because inequities in regulation create competitive handicaps and can impose severe economic burdens, the Commission must be prepared to act swiftly should competitive circumstances arise which require rule changes.

e. A particular market center (or self-regulatory organization) should not be prevented fro imposing a higher standard or rule on its market makers than is generally imposed on competing market makers, provided that the higher standard or stricter rule is not in itself anti-competitive in effect.

f. Consideration must also be given to rules applicable to dealers insofar as they may crate disincentives to market making. That is to say, individuals and firms will choose to become or not to become market makers of one kind or another depending on the balance of burdens and benefits involved.

The Board discussed, but reached no conclusion on, the question of whether the fact that a market center is now the primary market for a security should be taken into account in applying the concept of "equal regulation" and, if so, for how long after the removal of off-board trading restrictions.

2. Defining "Market Maker and Establishing Rational System of Privileges and Obligations

As a first step in the process of evaluating the need to continue, or extend to additional participants on a consistent basis, rules currently applicable to certain specialists or market makers, the Commission ought to have in mind a clear, single definition of "market maker." Its review of rules could then take the form of determining which privileges and obligations attach to the status generally and differentiate the market maker from other dealers, and what variations, if any, there should be among different types of market makers from time to time.

Currently there are several different definitions of "market makers" appearing in the Exchange Act and related rules. [Footnote: See, for example, Section 3(a)(38), Rule 15c3-1(c)(8), Rule 17a-9(f)(1), Rule 17a-16(c), proposed Rule 11Ac1-1(a)(1), and Regulation U of the board of Governors of the Federal Reserve System.] The definition in the Act itself was added in 1975, after most of the other definitions had been adopted. Unless there are sound reasons to suggest otherwise, it would seem appropriate to use the definition in the Act as a base definition for all purposes and then introduce modifications, distinctions or conditions, as appropriate, for some or all types of market makers in connection with rules as to particular topics such as credit privileges, capital requirements, access to facilities, and market responsibilities.

3. Obligations with Respect to Maintaining Fair and Orderly Markets, Including Price Continuity

The Board was divided on the question of whether the Commission, prior to removal of existing off-board trading restrictions, should amend Rule 11b-1 so as to free the New York and American Stock Exchanges from having to impose obligations relating to price continuity on their specialists. A bare majority of those present (Mrs. Miller and Messrs. Lorie, Putnam, Scanlon, Swinarton, and Weeden) believed the Commission should not consider amending Rule 11b-1

unless the affected exchanges requested such amendment, but, if requested, the Commission should act promptly to remove the rule.

These members suggest there is a reason to believe the exchanges will not request any change to Rule 11b-1 because the obligations imposed by it are considered by the exchanges to enhance the qualify of their markets and attract orders to them. These members conclude that, if those affected by the rule do not believe it creates an unfair competitive disadvantage, then there is no need to amend it.

In addition, at least some of these members voted as they did because they doubt the efficacy of Rule 11b-1. In their view, the general nature of the rule, and the many exceptions to the exchange rules adopted under it, result in specialists dealings that are not significantly different from those which would occur in the absence of the rule and that therefor the rule's existence does not create an unfair competitive disadvantage. Consequently, the also believe that extending a general rule to all market makers requiring them to intervene to promote price continuity would have little practical effect, and some believe, as a basic policy matter, the free play of market forces should be allowed to determine prices in all circumstances, without the required intervention of specified dealers.

Of the five members (Messrs. Cohen, Eshman, Guerin, Stone, and McCulley) who voted against merely waiting for the affected exchanges to request amendments to Rule 11b-1, at least three (Messrs. Cohen, McCulley, and Stone) believe there ought to be a more general rule on the subject in its place, such as the following, applicable to all market makers.

"A registered market maker's transactions in his designated securities shall constitute a course of dealing reasonably calculated to contribute to the maintenance of a fair and orderly market, including avoiding or mitigating price discontinuities due to temporary imbalances in supply and demand.

"No registered market maker shall enter into transactions or make bids and offers that are inconsistent with a course of dealing reasonably calculated to contribute to the maintenance of a fair and orderly market."

These members believe investor confidence would be enhanced if all market makers were obligated in a general way to maintain fair and orderly markets, and in particular to ameliorate temporary disparities in supply and demand.

4. Restrictions on Specialists' Direct Dealing with Institutional Customers

The Board unanimously agreed that if the New York or American Stock Exchange proposes the abolition of its rule prohibiting specialists from accepting institutional orders directly (New York Stock Exchange Rule 113 and American

Stock Exchange Rule 190), the Commission should approve such proposal, but that the Commission should not on its own require such rule change. It was the feeling of the Board that, given the possibility of increased competition in market making, the regulatory needs which prompted the adoption of these exchange rules would be less pressing, and would b outweighed by the unfairness of continuing to restrict New York and American Stock Exchange specialists if the exchanges concluded that these rules unfairly affect the ability of their specialists to compete.

However, at least one member of the Board (Mr. Cohen) who believed that primary market status is to be taken into account in applying the "equal regulation" concept (see final paragraph of Section 1 above), was of the view that approval by the Commission for either Exchange to abolish its prohibition may need to await the achievement of significant competition among market makers, and not just "the possibility of increased competition", so that primary market specialist would no longer have unique knowledge regarding most limit orders.

5. Restrictions on Market Makers Recommending or Disseminating Information or "Popularizing" Stocks in which they Make Markets

The Board unanimously agreed that if an exchange should propose the removal of any of its rules, originally promulgated a the Commission's direction, which restrict the ability of its specialists to recommend or disseminate information about stocks in which they specialize [Footnote: This recommendation was not intended to apply to information contained in limit order books, which may present separate questions.], such proposal should be approved, subject to a remaining requirement that any such information be accompanied by the disclosure of the fact that it was disseminated by a market maker who maintained positions, long or short, in the security.

It was noted by the Board that such disclosure was accepted as adequate regulation today for non-exchange market makers and that with the potential for increased market making competition in listed securities it ought to suffice for specialists. However, in the event that the Commission does not agree with the Board's recommendation in this regard it then ought to consider whether appropriately uniform restrictions on disseminating information regarding securities in which they make markets should not be imposed on all competing market makers, especially since there have been indications that firms might select stocks in which to make markets on the basis of their underwriting relationship with the issuer or their research activities, or both.

6. Needed Statutory Amendment

The Board repeats the suggestion it made in its May 19 letter that the Commission recommend to the Congress amendment to Section 11(b) of the Exchange Act to confer upon the Commission the authority to permit specialists to accept "not held" orders, such authority to be exercised if and when the Commission considers it appropriate to achieve equal regulation. Efforts should begin now to achieve the statutory change so that the Commission would be able to act promptly in the future if events should require it.

7. Other Problem Areas

Two areas not considered by the Board, but in which it senses important problems of "equal regulation" may exist are (1) the dissimilar regulations defining the ability of certain specialists and market makers to deal in options on the securities in which they specialize or make markets, and (2) the difference which Section 11(a) of the Exchange Act and the proposed Commission rules thereunder will impose on broker-dealer transactions in listed securities on exchange floors, and those "upstairs."

The Board is considering separately trading rules that might be applicable to market makers, such as obligations with respect to disseminating quotations, obligations to continue as a market maker once the role is undertaken, rules relating to priority of orders (insofar as they have not been covered in previous Board letters to the Commission), and obligations with respect to the protection of limit orders. Its discussions to date of these trading rules suggest that they also raise significant "equal regulation" issues. The Board plans to address such "equal regulation" issues in its letter to the Commission concerning these trading rules.

8. Dissent

One member, Mr. Stone, disagreed with the approach taken by the rest of the Board with respect to significant aspects of their interpretation of equal regulation. His view was that in the removal of Rule 390 the Commission has stated that the objective is to allow member firm capital and trading skills to compete with the specialist. With no affirmative obligations on the upstairs dealer having access to an internalized captive order flow and the ability to offset or create positions in the options market, the specialist is not given a fair field of competition at the outset of the removal of Rule 390. He felt that to create a fair field of competition all specialists and market makers should have similar minimum affirmative and negative obligations. He believed that the concept that the Commission would act at such time as the order flow has left the specialist and the primary exchange market and limit orders are internalized, has not support in historic Commission action, and gives no comfort that the handicapping basis of market makers will be updated daily, weekly, monthly, or

annually. All competitors should be treated on an even-handed basis and should have the same restraints as to price and role continuity, options, “popularizing”, etc. at the outset of the removal, and the Commission should not be a party to a handicapping exercise to reroute the order flow away from the primary exchange market, having permitted member firms to trade as principal over-the-counter. This member believed that the principles suggested by the Board would perpetuate unequal rules

Respectfully submitted,

NATIONAL MARKET ADVISORY BOARD

By: John J. Scanlon, Chairman