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December 6, 1977

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Securities and Exchange Commission  
500 North Capitol Street  
Washington, D. C. 20549

Dear Commissioners:

The Board is directed by the Exchange Act to “make recommendations to the Commission as to the steps it finds appropriate to facilitate the establishment of a national market system.” [Footnote: Section 11A(d)(3)(A).] We have from time to time submitted reports to the Commission in response to that statutory obligation, and again do so by transmitting the accompanying report. [Footnote: See letter to the Commission of September 24, 1976, regarding “In-House Agency Cross Transactions in Listed Securities by Exchange Members”; Letter to

the Commission of January 28, 1977, regarding "Establishment of a Composite Limit Order Book"; Letters to the Commission of February 25, 1977 and May 19, 1977, regarding "Off- Board Trading by Members of National Securities Exchanges"; Letter to the Commission of September 6, 1977, regarding "Regulation of Specialists and Market Makers in Light of the Proposed Removal of Off-Board Trading Restrictions".]

A variety of viewpoints are, by design, represented on the Board. Accordingly, rather than providing a single recommendation with respect to the next steps to be taken towards the establishment of a national market system, we provide a statement of major alternatives which we believe are open to the Commission, together with the reasoning of the members who support each. Also included are recommendations as to actions to be taken if the Commission chooses among these alternatives.

We hope you will find the report useful in your deliberations.

Respectfully submitted,

NATIONAL MARKET ADVISORY BOARD

By: John J. Scanlon, Chairman

REPORT TO THE SECURITIES AND EXCHANGE COMMISSION  
FROM THE NATIONAL MARKET ADVISORY BOARD

NEXT STEPS TO BE TAKEN TO FACILITATE  
THE ESTABLISHMENT OF  
A NATIONAL MARKET SYSTEM

December 6, 1977

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A. Initial Facilities to be Established in Connection with the Assumed Removal of Off-board Trading Restrictions.

There is a widespread belief that some new national market system facility or facilities ought to be established in connection with the removal of off-board trading restrictions if the Commission decides in favor of such removal.

[Footnote: The Board's views with respect to such removal are contained in its letter to the Commission dated May 19, 1977.] There is, however, a divergence of views as to what those facilities ought to be and what kind of actions, if any, the Commission ought to take to foster their establishment.

The Board has identified the following four major alternatives.

1. No Commission action beyond continuing involvement in the development of a composite quotation system. ("CQS only") [Footnote: The use of the abbreviation CQS to refer to a complex of rules and facilities constituting an effective systemwide composite quotation system should not be confused with the use of such initials by the NASD to refer to their existing listed quotation facility which is likely to form a part of a total effective composite quotation system. See Section D below.]

2. In addition, action to encourage establishment of intermarket linkage as, for instance, the Intermarket Execution System described by the National Market Association ("NMA"). ("IME type linkage") [Footnote: The Board understands that certain exchanges are presently engaged in the process of establishing a linkage of this general kind which they have named an "Intermarket Trading System" or "ITS". In addition, other exchanges have in operation in a limited number of stocks a facility which they call the "Regional Market System" or "RNS" which essentially performs the same functions.]

3. Commission action to encourage establishment of a composite limit order book designed to protect limit orders on a system-wide basis which facility would be in addition to, or in effect include, a composite quotation system and intermarket linkage, but which would permit execution of orders left in the system only by specialists and qualified market makers. ("Soft CLOB") [Footnote: The Board analyzed issues and made certain recommendations with respect to a composite limit order book in its letter to the Commission dated January 28, 1977. Since that time the Board has come to use the phrases "Hard" and "Soft"

CLOB. Although those categories were not used, the question of who should be able to execute orders in a CLOB is discussed at pages 13 to 17 of that letter.]

4. Commission action to encourage establishment of a composite limit order book with characteristics as described by Merrill Lynch, Pierce, Fenner & Smith, Messrs. Peake, Mendelson and Williams and Weeden & Co. ("Hard CLOB") [Footnote: In a Hard CLOB, orders in the book would always have priority at a price over any other orders in the system at that price. Some believe this might also be possible in a Soft CLOB. The subjects of time, price and book priority as well as public preference were discussed, with differing views stated, in our January 28, 1977 letter at pages 18 to 21.]

### 1. CQS Only

Messrs. Swinarton and Weeden are in favor of this alternative. They believe that additional necessary facilities would soon be established by the unlocking of competitive forces and without Commission intervention. Mr. Swinarton believes an effective CQS displaying competitive bids and offers in conjunction with the real time trade reporting through CTA provides sufficient disclosure of market information to maintain a realistic pricing mechanism and to discourage radical market fragmentation. He believes this new competitive environment should be allowed to function before a decision is made mandating a Soft or Hard CLOB.

Mr. Swinarton also believes an IME type linkage would be established by private initiative soon after removal of off-board trading restrictions, while Mr. Weeden believes a Hard CLOB would soon be developed.

Mr. Weeden feels that a Soft CLOB approach is unrealistic because a Soft CLOB would soon evolve into a Hard CLOB and that therefore constructing a Hard CLOB initially makes more sense. He believes this would be perceived by the industry and that a Hard CLOB would soon be established by private initiative. He rejects an IME type linkage because he views it as inherently inequitable in its design, and therefore believes it would be rejected by the Commission or the courts.

### 2. IME Type Linkage

Messrs. Guerin, McCulley, and Stone are in favor of this alternative. In Mr. McCulley's view, a Soft CLOB is a prelude to a Hard CLOB, which is in effect a unitary market, which he cannot accept personally or in terms of the Exchange Act. He therefore opts for a linked market system, since that is the only way he sees to maintain competition among markets as contemplated by the Act.

Mr. Stone agrees with Mr. McCulley and favors this alternative on the grounds that it is the proper way to preserve a good, cost effective market system. He feels that not only will a CLOB create a unitary market and eliminate exchanges, but that there is an overemphasis on limit order protection (30% of the orders executed) and not enough emphasis on the advantages auction markets afford by allowing brokers to achieve prices better than those quoted as well as to displace proposed transactions at better prices.

Mr. Guerin feels it is unwise to add more massive change to an industry already attempting to cope with extensive change. He observes that the full effects of negotiated rates are yet to be felt. In addition, he feels that rather significant cooperative developments such as the Regional Market System are being actively pursued in order for exchanges to offer improved services to their broker customers, the retail brokers who generate the orders transmitted to exchange floors. He would let the industry react to the variety of changed economic conditions, and recommend that the Commission be involved only to the extent of rule changes necessary to allow auction market linkage as requested by practitioners reacting to the demands of their customers.

### 3. Soft CLOB

Mrs. Miller, Messrs. Cohen, Eshman, and Scanlon are in favor of this alternative. These members think it important that some facility exist which would enable limit orders to be protected systemwide against trades at inferior prices. (This facility might be in addition to any other linkages which might be established). Messrs. Cohen, Eshman, and Scanlon think that, for various reasons, it cannot be taken for granted that a Soft CLOB would rapidly or necessarily turn into a Hard CLOB. Further, they believe that care must be taken to preserve the basic strengths of present markets. They therefore believe that the sound and prudent course is to accomplish system-wide limit order protection -- an important goal in itself -- and neither force nor assume the completion of more drastic steps prematurely. However, Mrs. Miller would specify that a Soft CLOB should provide both public preference and full time, price and book priority, and should be designed so that it could be adapted to a Hard CLOB. In her view continuing evolution from a Soft to Hard CLOB is desirable and important to the public. She sees a Soft CLOB as only an intermediate step to a Hard CLOB which would allow time for exchanges, their floor operations and the securities industry generally to adjust and possibly modify their present services in order to function in a fully electronic environment.

### 4. Hard CLOB

Messrs. Lorie and North are in favor of this alternative. Like the members who favor alternatives 1 and 2, both these members feel that a Soft CLOB would

quickly and inevitably lead to a Hard CLOB and so in their minds the issue is drawn between an IME type linkage and a Hard CLOB.

Mr. North also feels that a Hard CLOB would provide the maximum interaction of orders, thus most efficiently providing maximum liquidity and minimum spreads, and also, compared to the alternatives presented. The Hard CLOB would contribute the most to reestablishing the confidence of individual investors in the market process.

Both members favor a Hard CLOB on the grounds that most of the regulatory issues would be solved by its implementation and because they believe a Hard CLOB is the fairest and most efficient system. With regard to regulatory problems solved, they note particularly the questions of time and book priority, completeness and firmness of quotations and full limit order protection. In addition Professor Lorie believes a Hard CLOB would save investors a great deal of money.

#### B. How to Relate the Establishment of the Desired Facility to the Removal of Off-Board Trading Restrictions

If the Commission decides some facility should be established in connection with the removal of off-board trading restrictions, it must then decide how the establishment of the facility and the removal ought to be connected, if at all. As stated in our May 19 letter, the Board is of the unanimous view that rules and facilities comprising an effective composite quotation system should be in place prior to the removal of off-board trading restrictions. With respect to the establishment of an IME-type linkage or either type of CLOB, the Board considered three general ways in which such establishment and the removal of off-board trading restrictions might be related. [Footnote: In this and the next Section, those members who objected to a particular type of facility (IME-type linkage, Soft CLOB, Hard CLOB) nevertheless express views with respect to the means of establishing such a facility. They wish it to be noted that they do this based entirely on a hypothetical situation in which the Commission would require the establishment of facilities which these members continue to believe is not in the public interest.]

##### 1. Separate Action Taken With Respect to Each

In this approach, the Commission would not consider rule removal and facility development together but would take action with respect to each separately.

Those members of the Board (Messrs. Lorie, Swinarton, and Weeden) in favor of separate action if either an IME or some kind of CLOB are chosen, feel it is important that the removal of remaining off-board trading restrictions take place

promptly and that the coupling of removal to facility establishment would only delay removal. [Footnote: For practical reasons, Mr. McCulley believes separate action could be taken, if an IME-type linkage is found to be the desired facility. Steps to establish such a linkage are already underway and seem to him capable of culmination prior to any planned removal.] If these issues are linked, it is argued, the many members of the industry who do not favor either removal of off-board trading restrictions or the establishment of significant new facilities will have a double disincentive to cooperating with the Commission in the establishment of such facilities, for delay in facility establishment would then delay removal. These Board members believe that once restrictions are removed there would then be a positive incentive for these industry elements to cooperate in the prompt implementation of facilities to avoid the fragmentation they seem to fear. If so, it would then not take very long for appropriate facilities to be established.

## 2. Facilities Established Coincidentally with Removal

In this approach, the establishment of facilities would accompany rule removal, with an estimated date for establishment being set, and the Commission taking necessary action to insure that such date was met. (To the extent that facilities had to be phased in, e.g., several hundred securities at a time, removal of restrictions might occur on the same basis.)

Those members favoring this approach argue that if a particular type of linkage or composite book were found to be in the public interest and a necessary concomitant to the removal of off-board trading restrictions, it follows the facility ought to be in place at the time of the removal of the restrictions. [Footnote: Mrs. Miller and Messrs. Cohen, Eshman and Guerin favor this approach for an IME or CLOB type facility. Mr. McCulley favors it for purposes of a Soft or Hard CLOB. Mr. Stone favors it for purposes of an IME type linkage and abstained from choosing an alternative for purposes of either type of CLOB on the grounds that any kind of CLOB means the elimination of exchanges and is not in the public interest.] These members believe the double disincentive referred to in the immediately preceding subsection could be overcome if the Commission set specific deadlines and took firm action to insure these deadlines were met.

## 3. Removal on a Specific Future Date Set Sufficiently in Advance to Allow Time for Facility Establishment but not Conditioned on Such Establishment

In this approach, rule removal would be set for a specific future date on the assumption that necessary facilities could be established by that time, but removal would take place whether or not such facilities were in place.



Those members (Messrs. North and Scanlon, for all three types of facilities) favoring this approach believe it is the only practical way to insure timely establishment of a facility. They feel that even with firm Commission action, if establishment were a precondition to rule removal, the double disincentive would result in delays.

Timing. With regard to the timing of facility establishment, the Board is generally in agreement that an IME type linkage could be established a relatively short time from the date the Commission defined it as the appropriate facility. For implementation of a Hard or Soft CLOB, members have different views, but it is generally agreed that more time would be needed than for an IME type linkage. Although Board members have no special technical expertise, the Board has received a number of presentations estimating the time which it would take after the awarding of a contract to construct various kinds of CLOBs. In light of these presentations, certain Board members have formed general impressions of the approximate time period in which a CLOB could be constructed. Mr. Weeden has submitted a paper, based on his company's experience in developing and operating the WHAM system since February 1977, which outlines a plan for developing a full system CLOB within one year. Mrs. Miller also believes a CLOB could be built in a year or slightly longer. Messrs. North and Scanlon estimate such a facility could be implemented in that period if it were encouraged by the Commission and the rule removal were set at a specific future date.

### C. Means of Establishing and Administering Desired Facilities

If the Commission determines some facility ought to be established in connection with the removal of off-board trading restrictions, it must also decide what administrative approach should be taken to establish and administer the facility. The Board considered three alternative approaches: private initiatives, establishment of a new entity, and assigning the task to the NASD.

#### 1. Private Initiatives

In this approach, the Commission would not direct any existing organization to establish a facility nor would it mandate the formation of a new entity to do so. Rather, the Commission might prompt some initiative by adopting one or more substantive rules, for example, a rule like Rule 11Ac1-1 spelling out market maker obligations with respect to quotations, or a rule requiring all transactions to satisfy outstanding limit orders left at qualified market centers before a trade at an inferior price could take place. But it would leave to the industry the creation of the detailed procedures and facilities needed to comply with the rule.

All members of the Board voting on this question felt this to be the proper approach if the Commission determines that a COS is the only additional facility

required in connection with removal of off-board trading restrictions. Considerable progress on such a facility has been made to date by private efforts. With the enactment of appropriate Commission rules with respect to the quotation system, the members believe any additional efforts needed would be forthcoming from the private sector.

For similar reasons, all but one member voting favored the same approach be taken for an IME-type linkage if the Commission determined it was required. [Footnote: Messrs. Cohen, Eshman, Guerin, Lorie, Scanlon, Stone, Swinarton, and Weeden favor private initiatives for establishing an IME-type facility. Mrs. Miller does not because she believes it is important to have a separate entity representing the various interests of different segments of the securities industry and the public in any national market system undertaking, including the establishment of an IME-type linkage.]

Only Mr. Weeden favors this approach for a CLOB. He feels it even more appropriate with respect to a CLOB for the Commission to limit its involvement to prescribing goals and promulgating rules and regulations. Allowing private initiative to develop the facility would allow more flexibility in designing a system, as opposed to the Commission mandating specific characteristics. The other members doubt that a functioning systemwide CLOB could actually get constructed if the Commission so limited its activities.

## 2. New Entity

In this approach, a new entity would be formed, at the direction of Congress or the Commission, specifically for the purpose of creating the designated facility. This could be along the lines of the CTA, NMA, or the National Market Development Corporation proposed by the SIA. Six members of the Board favor this approach for a CLOB (Mrs. Miller and Messrs. Eshman, Cohen, Guerin, McCulley, Scanlon, and Stone).

Mr. Eshman specifically recommends the creation of a National Market Board composed of members broadly representative of the industry and the public which would have the authority (including contracting authority) to design and establish any facility, subject to Commission oversight and to promulgate rules and regulations for its use. [Footnote: Mr. Eshman proposes a 13 member board composed of the chief executives of the New York Stock Exchange, the American Stock Exchange, a regional exchange, the NASD, a full line national broker-dealer, a regional broker-dealer, a third market maker, a major investment banking firm, a major publicly held company, a small to medium sized publicly held company, the national clearing organization, and a senior officer of a major institution (bank, insurance company, mutual fund, etc.). There would also be included the chief executive officer of the Board. Such persons could be designated by the Commission from nominations made by specified groups or

the public generally. Technically the Board could be formed either by an Act of Congress or an order of the Commission requiring the existing self-regulatory organization to incorporate such a body pursuant to Section 11A(a)(3)(B) of the Exchange Act. The Board would then register with the Commission as an exclusive securities information processor.]

He reasons that credibility and industry-wide support would accrue only to a newly formed body. Mr. Eshman also suggests that the Commission be required to report periodically to the Congress on the proposals of that board which the Commission did not accept, explaining the reasons why it so acted. He favors this approach for the purposes of a Soft or Hard CLOB.

Mr. Cohen, without necessarily endorsing every detail of the Eshman proposal, believes that something close to it would be essential if there is to be an effort to go directly to a Hard CLOB. But if the immediate goal is something less, such as a Soft CLOB (as he believes it should be), he would hope that, with the Commission taking a more effective role than heretofore, industry initiatives through a vehicle such as CTA, OCC, or NMA would suffice. [Footnote: Mr. Cohen suggests the possibility of a nine member board, three representatives of self-regulatory organizations (one from the New York Stock Exchange and American Stock Exchange, one from the regional exchanges and one from the NASD), three representatives of different types of broker-dealers, and three representatives of the public.]

Mrs. Miller agrees with Mr. Eshman's concept modified as follows. There should be approximately three representatives of the investing public on the board and it should be established by the Commission rather than the Congress. She would recommend it not only for a CLOB but also for an IME. Because of the necessarily large size of the board, she suggests there might have to be a smaller executive committee to insure the decision making process does not become unwieldy, and perhaps a technical committee as well. Mrs. Miller also is of the view that such a board need not preclude or interfere with choosing the NASD to develop technically the chosen facility.

Messrs. Scanlon and McCulley generally agree with Mr. Eshman's proposal but would not object to such a new body being established under the aegis of the NASD.

Mr. Guerin would create a new entity not composed of representatives from existing organizations. [Footnote: Mr. Guerin emphasizes that he opposes the establishment of any kind of CLOB and discusses its implementation only on the assumption that the Commission makes the decision that one must be established.] He would envision a primarily technical group, including persons with expert knowledge of data processing systems in the industry and persons with securities trading experience in various environments [Footnote: Establishment of the entity, appointment of persons thereto and registration with

the Commission could be carried out as described in the last three sentences of the footnote on page 11.] The body would have a minimum of policy making authority. The Commission would promulgate all system rules. He thinks this approach best for either a Soft or Hard CLOB as he reasons that a body which had representatives of existing organizations would merely perpetuate old divisions as the representatives fight for the interests of their respective constituencies. Mr. Stone would follow this approach if the facility chosen is either type of CLOB. [Footnote: Mr. Stone emphasizes that he Opposes the establishment of any kind of CLOB and discusses its implementation only on the assumption that the Commission makes the decision that one must be established.] These two members argue that if the Commission specifies the details of the CLOB it believes should be constructed, there will be little need for a high level policy making body to implement the decision.

### 3. NASD

In this approach, the NASD would be given the responsibility to create the designated facility. The current organization and structure of the NASD would be used with the addition of a special new entity for this project. This entity could be in the form of a new committee, or a new wholly owned subsidiary such as NASDAQ, Inc. Messrs. Lorie and Swinarton favor this alternative for either kind of a CLOB.

These members feel that the NASD should be chosen because it is an existing Organization with a well established relationship to the Commission and because it has had experience in the design and implementation of an automated market facility, NASDAQ. Further, it has a widely based membership and operates under statutory authority which allows great flexibility in the creation of subsidiaries or affiliates, such as NASDAQ, Inc. It is noted that such a subsidiary could have constituencies such as specialists and floor traders represented in a significant way even though the NASD itself does not. In fact, such a subsidiary could have the same composition as any new entity described by those favoring the preceding approach.

Professor Lorie feels that if the NASD is not politically acceptable to the New York Stock Exchange and others, then a new entity might be created. He feels this should not be the reaction of the New York Stock Exchange because the NASD would seek full representation from that exchange if the NASD were chosen to implement the facility. [Footnote: Those who recommend against assigning the responsibility for initiating a Hard CLOB or Soft CLOB to the NASD or any creature of the NASD, do so because they feel that a body created to regulate the over-the-counter market -- a dealer market -- simply does not have the expertise and experience, and may not have the motivation to do the job contemplated by Congress, which, in their view, is to preserve the best qualities of auction-agency markets while moving towards a national market system.]

#### 4. Financing

It appears that financing arrangements have already been made for the major elements of a COS and IME-type linkages such as the ITS and RMS. Board members are generally of the view that financing the construction of a CLOB would not be a problem if there existed a properly formulated Commission rule which made clear that the CLOB would be widely used and that the entity administering it would be authorized to charge fees calculated to recover the initial investment within a reasonable time. With such a rule, it is believed that the entity responsible for establishing the CLOB would be able to borrow the funds needed to construct it from a lending institution or could ask those bidding to build the facility to advance the necessary funds. [Footnote: In the latter regard, see letter of April 30, 1976, from George M. Hernan, Vice President - Business Planning, CTE Information Systems, Incorporated, to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, responding to the Commission's request for public comment on issues related to a composite central limit order repository, at p. 21. At least one Board member (Mr. McCulley) is of the view that it would be inappropriate for the NASD to use its assessment power to finance the construction of any such facility.]

#### D. Need for an Effective CQS

The Board believes there should be in existence at the time of the removal of off-board trading restrictions an effective CQS. [Footnote: However, if the Commission requires that a Hard CLOB be in existence at the time of removal (or the industry on its own initiative develops such a facility by that time), then a COS would not be needed because of the all-encompassing nature of the Hard CLOB.]

The Board explained why it believes a CQS is needed in its letter of May 17, 1977 to the Commission (at pages 7 and 8). Here it sets forth its views as to what is required to make such a system effective. [Footnote: The Board has previously stated that it also believes that certain changes in Commission rules are required coincidentally with the removal of off-board trading restrictions and that certain changes in exchange rules should be permitted, in order to ensure that "equal regulation" exists upon removal. See our letter of September 6, 1977.]

1. General. The Commission's proposed Rule 11Ac1-1 foresees each self-regulatory organization ("SRO") having the responsibility to collect quotations from its market maker members and to make such quotations available to vendors. Alternatively, the Board believes the Commission ought to consider in more detail the advisability of having only one organization (an existing SRO, a new body similar to the CTA or an independent vendor) collect quotations,

sequence them as required by applicable rules, and then make the resulting data stream available to vendors. This is the general approach which was followed in establishing the consolidated tape and should be explored in this case.

## 2. Characteristics of an effective system.

(a) All quotations furnished to the system should be displayed on a rational and equitable basis. The system should provide a service which displays all quotations entered in a particular security in a montage, with bids and offers displayed in a rational order and identified as to their source. In case of vendors supplying a service displaying only a single bid and offer, it should be the best bid and the best offer from among all quotations, with the source(s) of each identified. It should be no more difficult to call up the quotations of one market maker or market center than any other.

(b) Quotations should be firm. Quotations should be firm to the same extent as quotations entered in the NASDAQ system, and rules similar to those which the NASD has with respect to “backing away” from NASDAQ should be promulgated for quotations entered into the CQS. The Board does not believe that the other exceptions to firmness provided for in the Commission’s proposed Rule 11Ac1-1 are necessary or desirable. [Footnote: This is stated without intending to pass judgment on considerations applicable to market centers with CBOE-type competing market makers, such as those raised by the CBOE in its comments on Rule 11Ac1-1.] The Board reasoned that inasmuch as quotations made orally on the floor of an exchange are firm, such oral quotations could, with the proper support personnel, be expeditiously entered into the CQS and expeditiously changed when changed on the floor. The Board is also of the opinion that, as a legal matter, quotations should be firm only to broker-dealers, as with NASDAQ, and, unlike the provision in proposed Rule 11Ac1-1, should not be firm directly to customers. The Board notes, however, that because of a broker’s fiduciary obligation to its customer, as a practical matter, the prices reflected in a broker-dealer’s quotation would most likely be available to its customers, plus or minus its normal commission or commission equivalent.

(c) Display of size would be useful but is not necessary.

(d) Market makers should not be required to enter quotations in the system. Contrary to the requirement contained in proposed Rule 11Ac1-1, the Board is of the view that requiring market makers to include their quotations in the CQS might impose equipment and personnel costs that would discourage many broker-dealers from making markets. The Board believes it likely that broker-dealers which made markets in a significant number of securities would enter quotations into the system for at least some of the securities in which they made

markets, and that the degree to which market makers entered quotations into the system would depend on the degree to which the system was used in directing order flow. If the system did not influence the direction of order flow, it would seem unfair to require market makers to make expenditures that were unlikely to have any business purpose. However, one member, Mr. Stone, feels that if the intention of the removal of off-board trading restrictions is to encourage competition, the public is entitled to information as to the willingness of all market makers to buy and sell, and market makers ought, therefore, to have an obligation to include their quotes, including public orders, in the CQS. Nevertheless, he would accept optional entry of professional quotations if the New York and American Stock Exchanges were relieved of the obligations of Commission Rule 11b-1 that their rules require specialists to make continuous firm quotations.

(e) Rules should be designed so as to ensure the system is used only by broker-dealers providing bona fide two-sided quotations. Vendors should not be required to disseminate quotations of broker-dealers who provide only bids or only offers. Rules regarding spread parameters and locked or overlapping quotations, like those applicable to NASDAQ, ought to be applicable to broker-dealers entering quotations into the system in order to help insure that such quotations are bona fide two-sided. Such requirements will keep the system from being used merely as a broker order system or an advertising device for brokers to show they have an interest on one side of the market. [Footnote: Mr. McCulley felt that the ease of access proposed by the Board would permit what are, in effect, one-sided quotations, noting that the spread parameters are sufficiently broad to permit a dealer's one-sided interest to be readily apparent from the relative competitiveness of the two sides of his quotation. Such flexibility, coupled with the removal of off-board trading restrictions on members of exchanges and the total freedom of entry and withdrawal as a participating market maker, would, in his opinion, not result in a good market maker system, but rather a system for all broker-dealers to advertise interests from time to time. He favored, therefore, rules such as those proposed by the Yearley Committee with regard to commitments to participate actively for some period of time, and penalties for premature withdrawal.]

(f) Broker-dealers SRO's or other entities which make quotations available to any vendor should be required to make them available to all interested vendors.

#### E. "Best Execution" Obligations Should Off-Board Trading Restrictions be Removed.

The Board is divided with respect to the action the Commission should take regarding best execution obligations if and when off-board trading restrictions are

removed. Five of the members voting (Messrs. Eshman, Guerin, McCulley, Stone, and Swinarton) believe that the only action which the Commission should take is to review periodically execution practices of broker-dealers in light of evolving availability of facilities for (i) obtaining access to markets, (ii) obtaining current trading information from market centers, and (iii) order routing. The other six members voting (Mrs. Miller and Messrs. Cohen, North, Putnam, Scanlon, and Weeden) believe that the Commission should take action at three different levels, generally as recommended by the Midwest Stock Exchange in its Policy Statement on the Objectives, Development and Governance of a National Market System ("Midwest Statements"). [Footnote: pp. 31-35]

First, the Commission should adopt a rule in effect articulating existing notions of a broker's fiduciary responsibility which would state the obligation of a broker "to use reasonable care consistent with high standards of professional skill and integrity to obtain the best price for a customer ..." [Footnote: Midwest Statement at page 33. This is not unlike the standard currently contained in the NASD interpretation entitled "Execution of Retail Transactions in Over-the-counter Market" (excluding the accompanying list of factors contained therein). The members favoring this approach do not believe that any such rule should contain a list of factors to be taken into account in judging the reasonableness of a broker's action, for any such listing necessarily must be incomplete, and attempting to amplify and qualify the list properly would make it too complicated to be useful. The rule proposed in the Midwest Statement is also like the general approach taken in proposed Commission Rule 15c5-1(D) which, however, is worded to apply only to a broker-dealer executing a transaction off the floor of an exchange, and these members of the Board contemplate a rule which would be applicable to broker-dealers no matter where they executed their customers' orders.] The rule adopted by the Commission would facilitate administratively the Commission's ability to enforce and interpret best execution obligations.

These members note that a broker-dealer's obligation to use reasonable efforts to obtain best execution for his customer is intimately connected with the availability and cost of access to markets and facilities at the particular time in question. Therefore, the second level on which they believe the Commission should take action is to foster industry or governmental efforts to extend and improve communication linkages and electronic data processing facilities to enable broker-dealers to achieve higher standards of best execution efficiently and economically.

The third level on which these members believe the Commission should act is through rules, interpretations or other communications to the brokerage community from time to time, as progress is made in creating and improving linkages and electronic data processing facilities, to the effect that the general obligation of best execution includes the duty of a broker to make reasonable efforts in light of his circumstances (his location, volume and nature of his business. etc.) to avail himself of existing linkages and facilities.



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The foregoing statement of views and analysis makes clear the complexity and importance of the issues which the Commission faces in deciding what are to be the next steps towards the establishment of a national market system. The Board believes that in this and its prior communications to the Commission it has addressed the major issues presented. One issue not addressed, which the Board believes is of importance, is that of the securities to be included in the system. The Board hopes to provide a supplement to this report dealing with that issue by the end of the year.