The New York Stock Exchange & The National Market System

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Key Elements of a National Market System

Overview

Six major issues are at the center of the evolution of a National Market System for competitively traded stocks.

1. Reporting of transactions
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Through a succession of consistent and interrelated positions, the NYSE NMS approach addresses each of these issues. The current priority goals are to improve the data processing and communications linkages associated with the Intermarket Trading System (ITS) and to develop the concept of the Market Center Limit Order File (MCLOF) including the open display of public limit orders. The common denominator of all the NYSE NMS positions is that the step by step evolutionary process must be guided by and provide for a broad range of competition. Specifically this means, *competition among market centers, among market-makers, and among orders.*

This strategy has crystalized over the past year as the Exchange has articulated its NMS alternatives in position papers submitted to the SEC. The Exchange positions emphasize development of five major elements without compromising the exchange market process or eliminating the key element of human judgement in the pricing and trading of securities.

Reporting of Transactions

The development of the Consolidated Tape marked the operation of the first key NMS element. Last sale information in NYSE listed issues—regardless of the market center where the transaction takes place—has been reported on Network A of the Consolidated Tape for more than three years. The NYSE has always believed that investor confidence and the pricing mechanism in the marketplace is enhanced by quick dissemination of actual transactions and price information. Further, the disclosure and surveillance responsibilities of qualified NMS market centers require real-time reporting of trades in all NMS-eligible securities. The NYSE continues to believe that the inclusion of identifiers on the tape to indicate in which market center the trade took place is in the public and broker's interest.

Dissemination of Quotes

Enabling all interested parties to see prices at which market-makers in each qualified marketplace are currently willing to buy and sell stock was recognized as a key element early in NMS discussions. The Composite Quote System began operation in August 1978. The Composite Quote Rule requires that market-makers be able to reflect current quotations with size and that these quotes be firm. The NYSE supports the concept of firm quotes and the quick and accurate dissemination of quote information. In the ITS Operating Plan competing quote information is cited as the impetus to direct orders through ITS. Each Participant has agreed to provide for the efficient collection and distribution of quotes and sizes from all of their specialists/market-makers. Prominently displaying such information made available from other Participants is also part of the agreement.

Clearing of Trades

The Securities Act Amendments of 1975 called for the capability to clear and settle transactions from any market center without incurring economic disadvantages because of geographic location. The NYSE supports a national clearing structure. An important step toward this goal was taken in 1975 with the interaction of various market centers through the Regional Interface Organization (RIO). The NYSE supports the continuation of such progress so that the advantages of linked, competitive clearing organizations can be extended nationwide.

An integrated national clearing structure will eliminate duplication and permit single account clearance and settlement for broker/dealers in the clearing organization of their choice.

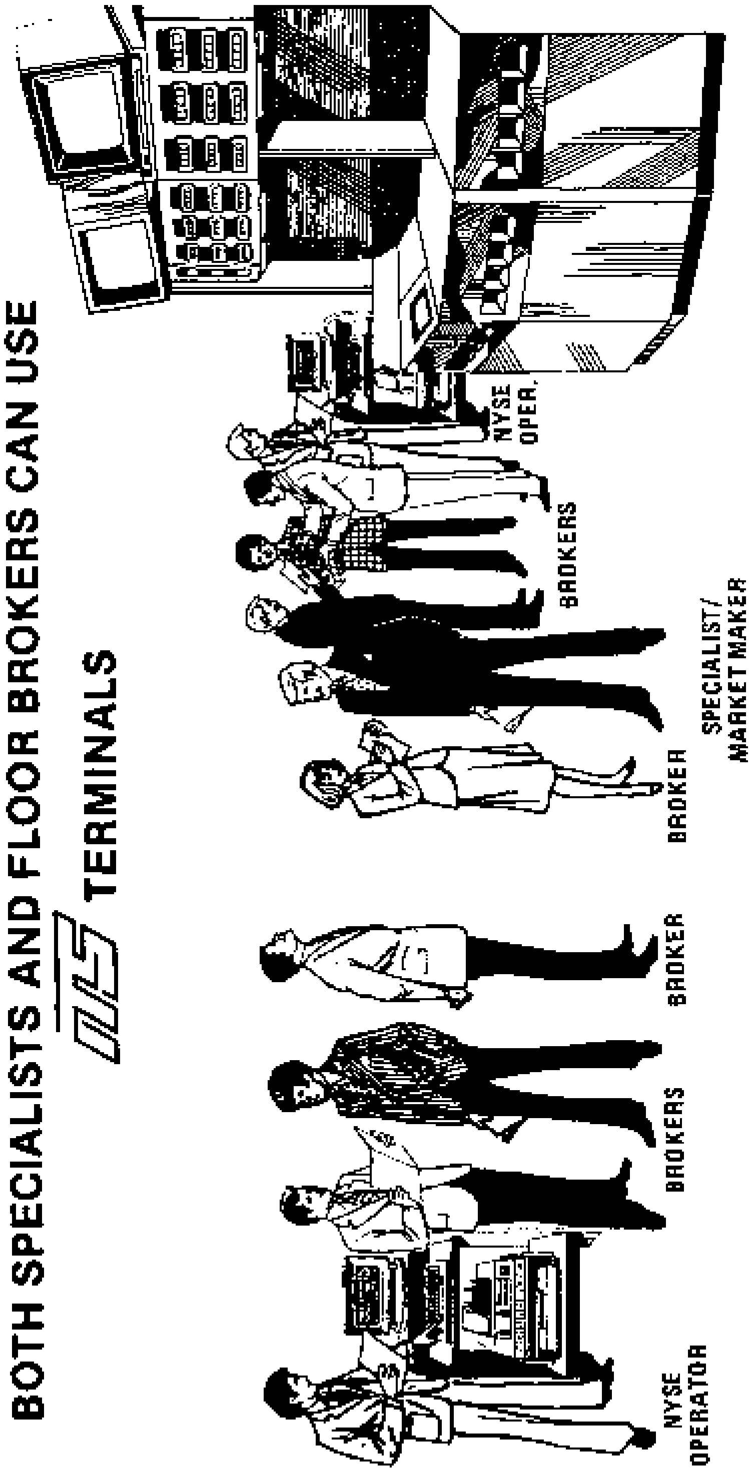
Order Routing and Message Switching

The SEC, in its January 1978 release outlining the elements it believed were necessary for the completion of an NMS, called for a ''neutral'' switching and routing system available to all participants. The NYSE opposed the development of such a facility. The major reasons for opposition were:

- The development of a central switching facility was redundant because a majority of brokers representing over 90% of all orders have access to electronic switching capability today. Either they had in house capability, used correspondent facilities, or utilized outside systems which provide this service.

- If the SEC aim was to move toward some type of automatic formula routing based on quotes this would severely lessen competition among market centers, orders, and market makers. Quotes are only one element in establishing total value to a customer. Other elements including service, convenience, costs, etc. are relevant considerations when a firm is deciding where it will send its business.

- If formula routing is a good idea, a broker will develop it as a competitive offering to customers. This type of private enterprise is preferable to a government mandated formula system.



Linking of Markets

The key element in the NYSE NMS strategy is the Intermarket Trading System which has been successfully operating since April 1978. Most proponents of an NMS have agreed that the ability to trade across market centers was an essential element to make the NMS effective. The particular problem was how to accomplish this while at the same time preserving the unique trading characteristics and different market structures existing in each market center. The NYSE has stressed that the linkage concept is superior to a monolithic market structure because it provides maximum competition between market centers, orders, and market-makers. The early experience with ITS has demonstrated this thesis to be correct: It has also shown that the industry itself has a growing ability to resolve major issues that effect the development and operation of an NMS.

Protection of Public Limit Orders

The last, and perhaps the most difficult, issue left in the development of an NMS is limit order protection for orders wherever entered into the system. The question is how much protection is necessary to increase investor confidence and at what costs to the market system and its participants. Some have suggested that a Central Limit Order File (CLOF) needs to be built. This central file would store all limit orders entered on all market centers. The orders in it would have complete time and price priority over all other orders. Market-makers wherever located would be able to execute against this file.

The NYSE opposed this approach as too expensive, too monolithic, leading to the separation of large and small orders discouraging to competition, and a threat to the entire exchange market system. The NYSE does however, recognize the need to extend limit order protection in an NMS. As such, it has proposed an alternative solution which it is preparing to implement. This alternative again is structured within the framework of preserving maximum competition among market centers, orders, and market-makers. This proposal was put forth in the Exchange's May 31, 1978 submission to the SEC. The proposal calls for four interrelated and mutually dependent elements.

- Expansion and enhancement of ITS so that better bids and offers may be reached for in other market centers quickly and efficiently, thus enabling participants to protect public limit orders.

- Development of an electronic market center limit order file or similar type device to allow electronic display of public limit orders in each market center. In the NYSE file, limit orders will be able to be loaded, statused and cancelled by member firms and market-makers.

- Development of a block enhancement system utilizing the combined display of all market centers' public limit orders. This will enable participation of limit orders in various market centers in any trade occurring outside the quote in any market center.

- Encouragement of market-makers and brokers to ensure that they utilize the available mechanisms to get the best price for their customers and thereby fulfill their agent responsibilities.

Conclusion

By building on the strengths of the present exchange auction market system, and with careful monitoring and evaluation, nationwide public limit order protection can be strengthened and integrated with the other key elements already in place to achieve an NMS. Progress to date indicates that an industry directed evolutionary process can best achieve—in a minimum of time and at a realistic cost—the goals of a National Market System without adversely affecting market quality.

Moreover, related developments at the Exchange—such as the extensive Facilities Upgrade project and imminent DOT System enhancements—leave no doubt that the NYSE is strengthening its competitive position in the evolving NMS. The NYSE goals are to reduce securities industry operating costs, while maintaining high standards of service to customers. These goals underly the Exchange's business posture in both the development of a National Market System and the day-to-day operations of the NYSE trading facilities.

CHRONOLOGY OF KEY NATIONAL MARKET SYSTEM AND RELATED DEVELOPMENTS

March 1971	SEC transmits Institutional Investor Study Report to Congress. "A major goal and ideal (should be) the creation of a strong central market system for securities of national importance, in which all buying and selling interest in these securities could participate and be represented under a competitive regime."
August 1971	William McChesney Martin, Jr. recommends to NYSE, among other things, "development of a national exchange system which would provide a national auction market for each listed security."
February 1972	SEC Statement on The Future Structure of The Securities Markets called for "a system of communications by which the various elements of the marketplace, be they exchanges or over-the-counter markets, are tied together." It also includes a set of proposed rules governing the relationships which will prevail among market participants.
March 1973	SEC Policy Statement on The Structure of A Central Market System stresses "the preservation of an auction-agency market" and the need for an "efficient and comprehensive communications linkage between market centers, consisting of a real-time composite transaction reporting system and composite quotation system displaying all bids and offers of all qualified market-makers in listed securities."

1973 - 1975 Congress begins process of shaping new securities legislation. Chairman John Moss (House Committee on Banking, Housing and Urban Affairs) and Chairman Harrison Williams (Senate Committee on Interstate and Foreign Commerce) launch exhaustive studies of securities industry, culminating in the Securities Acts Amendments of 1975.

May 1975 Competitive public commission rates replace fixed minimum rates which had governed investors' fees for brokerage services for 183 years.

June 1975 President Ford signs Securities Acts Amendments, giving National Market System concept the force of Federal law and empowering SEC to oversee development and implementation of the system.

> "The securities markets are an important national asset which must be preserved and strengthened."

> "The linkage of all markets for qualified securities through communication and data-processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders."

June 1975 Consolidated Transaction Reporting System—first major element of evolving National Market System—begins full operation.

December 1975 SEC's National Market Advisory Board begins functioning as forum for determining characteristics and components of National Market System.

March 1976 NYSE's Designated Order Turnaround System begins operating on pilot basis, transmitting orders and reports between member firm offices and Exchange trading floor.

March 1976 NYSE adopts Rule 390, replacing NYSE Rule 394, complying with earlier SEC order requiring that member organizations be permitted to take agency orders to non-exchange markets, provided public limit orders on specialist's book are satisfied.

November 1976 National Market Association formed by the principal securities industry organizations and leads to the formulation of a preliminary linkage concept known as Intermarket Execution System (IMF).

August 1977 At a Pacific Stock Exchange Board Meeting, NYSE and PSE agree to electronic linkage of their trading floors.

August 1977 SEC conducts public hearings on the proposed removal of off-board trading rules.

January 1978 SEC releases a summary NMS statement setting forth particular steps considered necessary to NMS implementation and a timetable for implementing and/or responding to Commission proposals.

March 1978 Intermarket Trading System (ITS) Operating Plan, signed by the American, Boston, New York, Pacific,

	and Philadelphia Stock Exchanges, submitted to the SEC for approval.
April 1978	Intermarket Trading System begins pilot operation with trading in eleven competitively traded issues between the floors of the Philadelphia and New York Stock Exchanges.
April 1978	Midwest Stock Exchange becomes the sixth Market Center Participant in ITS.
April 1978	SEC approves nine-month pilot operation of the Cincinnati Stock Exchange's experiment in automated trading with upstairs market-making participation.
April 1978	NYSE submits response to the SEC on proposed industry order routing switch, expressing the willingness to cooperate. The NYSE joined in industry-wide sentiment not to add yet another non-discriminating order-routing system to the several already in existence.
May 1978	NYSE submits its response to the SEC on development of a Central Limit Order File, pointing out problems with such a file and proposing an alternative approach to meet the standards set by Congress in the 1975 Act.
August 1978	Composite Quote System begins operation, establishing another working NMS element.
August 1978	Six Participants actively trading over 150 issues through ITS. SEC approves the extension of ITS trading beyond the original pilot operation.
October 1978	NYSE Board of Directors approves 9.5 million dollar allocation of funds for extensive Facilities Upgrade Program.