ORDER EXPOSURE RULES: A STATUS REPORT

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OFF-BOARD TRADING RESTRICTIONS

In 1975, Congress directed the Securities and Exchange Commission ("Commission") to facilitate the development of a national market system. While not detailing the future structure of that system, Congress did provide the Commission and the industry with a number of guiding objectives. Among these objectives was the enhancement of fair competition between and among brokers and dealers, exchange markets, and markets other than exchange markets. 1/ Consistent with the Congressional desire to enhance competition through the removal of unnecessary regulatory restrictions, Congress specifically instructed the Commission to examine exchange off-board trading restrictions, which prevent exchange member firms from effecting transactions in listed securities other than on an exchange, and to remove off-board trading restrictions that have anti-competitive effects not otherwise justified by the goals or purposes of the Act. 2/

Pursuant to the Congressional directive, the Commission carefully examined off-board trading restrictions, and concluded that these restrictions were indeed anti-competitive

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1/ Section 11A(a)(1)(C)(ii) of the Securities Exchange Act of 1934 ("Act").

2/ Section 11A(c)(4)(A) of the Act.

and inhibited market making in listed securities. 3/ However, the Commission also recognized that the elimination of off-board trading restrictions with respect to principal transactions involved potential risks of internalization 4/ of retail order flow by member firms of the primary exchange, which in turn raised market fragmentation and fiduciary concerns. Consequently, the Commission has proceeded with caution in addressing off-board principal restrictions.

During the following four years, the Commission instituted three separate proceedings which considered the full or partial abrogation of these rules. 5/ At the conclusion of the

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3/ See Securities Exchange Act Release No. 11942 (December 19, 1975), at 5-7, 41 FR 4507, 4509; Securities Exchange Act Release No. 13662 (June 23, 1977), at 36-38, 42 FR 33510, 33514 ("June Release").

4/ The Commission has defined the term "internalization" as referring to "the withholding of retail orders from other market centers, for the purpose of executing them in-house, as principal, without exposing those orders to buying and selling interest in those other market centers." See Securities Exchange Act Release No. 16388 (June 11, 1980), at 18, n.31, 45 FR 41125, 41128, n.31 ("Rule 19c-3 Adoption Release").

5/ Securities Exchange Act Release No. 11942 (December 9, 1975), 41 FR 4507 (Adoption of Rule 19c-1 which removed off-board agency restrictions); Securities Exchange Act Release No. 13662 (June 23, 1977), 42 FR 33510 (Proposed Rule 19c-2, which would have removed all off-board principal restrictions, was ultimately withdrawn, Securities Exchange Act Release No. 16889 (June 11, 1980), 45 FR 41156); Securities Exchange Act Release No. 16888 (June 11, 1980), 45 FR 41125 (Adoption of Rule 19c-3 which removes off-board principal restrictions for securities listed on an exchange after April 26, 1979).

most recent of those proceedings, in June of 1980, the Commission adopted Rule 19c-3 under the Act, precluding the application of off-board principal restrictions with respect to certain securities newly-listed on an exchange. As a result, integrated New York ("NYSE") and American Stock Exchange ("Amex") member firms are now permitted to make markets in certain exchange-listed securities in direct competition with exchange specialists. 6/

In adopting Rule 19c-3, the Commission concluded that, at least with respect to Rule 19c-3 Securities, the benefits of preserving existing OTC market making in competition with exchange markets, combined with the experiential benefits to the Commission and the industry of observing actual concurrent trading of listed securities by exchange markets and OTC market makers, outweighed the potential risks that might result from removing exchange off-board principal restrictions. In deciding to take action with respect to these principal restrictions, the Commission fully considered internalization concerns identified by commentators, including the potential problems of

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6/ Specifically, Rule 19c-3 precludes exchange off-board trading restrictions from applying to reported securities (i.e., securities for which transaction reports are made available pursuant to an effective transaction reporting plan), which were listed on an exchange after April 26, 1979 (the date of the proposal of Rule 19c-3) or which were listed on April 26, 1979, but ceased to be traded on an exchange for any period of time thereafter ("Rule 19c-3 Securities").

overreaching of customers by OTC market makers, 7/ the fragmentation of order flow among market centers, 8/ and adverse competitive effects on exchange market makers and small broker-dealers. 9/

Although the Commission determined to proceed with the Rule 19c-3 experiment, it recognized the significance of the potential internalization concerns raised by commentators. In response, the Commission suggested, in the Rule 19c-3 Adoption Release, several means by which internalization could be addressed if problems developed in the future, including a rule requiring market makers to hold out agency retail orders to other buying and selling interest for a minimum period of time before executing against that order as principal. 10/ In

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7/ "Overreaching" refers to broker-dealer firms taking advantage of their customers by executing retail transactions as principal at prices less favorable to those customers than could have been obtained had those firms acted as agent. See June Release, supra note 3, at 70-84, 42 FR at 33519-21.

8/ Commentators have argued that fragmentation of order flow among disparate market centers potentially might result in a deterioration of the depth, liquidity and continuity of the markets, and a decrease in pricing efficiency. See Rule 19c-3 Adoption Release, supra note 4, 45 FR at 41128.

9/ Id.

10/ Rule 19c-3 Adoption Release, supra note 4, 44 FR at 41129. In addition, several alternative rules, proposed in the context of the earlier Rule 19c-2 proceeding with respect to off-board trading restrictions, remain outstanding. See June Release, supra note 3, 42 FR at 3525.

addition, an ongoing surveillance program was established by the Commission, in conjunction with the National Association of Securities Dealers, Inc. ("NASD"), to monitor the effects of Rule 19c-3 on the markets, and to detect and take action with respect to any problems that might develop. The Commission also indicated, however, that some internalization type concerns are also present in the trading of listed securities on exchanges, because orders sent to an exchange market are not necessarily exposed to other markets even where there is a superior quotation displayed by another market. 11/

In addition, at the time Rule 19c-3 was adopted, the Commission recognized the limited utility of this experiment without the existence of an efficient intermarket linkage that could foster effective OTC competition for exchange order flow. Without such a linkage, OTC and exchange market makers would have difficulty in executing their customers' orders in the best market if orders could not be efficiently routed to that market. Moreover, OTC market makers would have little ability either to interact with the vast majority

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11/ Rule 19c-3 Adoption Release, supra note 4, 45 FR at 41129. Although the ITS participants have adopted trade-through rules that limit the execution of trades at prices inferior to the displayed quotation of another market, see Securities Exchange Act Release No. 17704 (April 9, 1981), 46 FR 22520, it appears that orders initially directed to an exchange often are retained there as a result of the specialist's matching, for the purpose of an individual order, the superior quotation of another market.

of retail orders which are routed to the primary exchange markets or to attract additional order flow through their displayed quotations. Accordingly, the Commission in April of 1981 ordered the implementation of an automated interface between the Computer Assisted Execution System ("CAES") operated by the NASD (representing the OTC market makers) 12/ and the Intermarket Trading System ("ITS") 13/ operated by seven national stock exchanges.

ORDER EXPOSURE

In the context of the linkage order, "order exposure" 14/ continued to be a focal point of discussion. Once again, a number of commentators expressed concern over the dangers of

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12/ CAES is a computerized order routing and execution facility which is made available to NASD members using the hardware of the NASDQ automated quotation system.

13/ The ITS is an intermarket communications system operated jointly by certain national securities exchanges and the NASD and authorized by the Commission, on a provisional basis, as a national market system facility pursuant to Section 11A(a)(3)(B) of the Act. The current participants in ITS are the NASD and the NYSE, Amex, Boston, Cincinnati, Midwest, Pacific and Philadelphia Stock Exchanges. The NASD became an ITS Participant as of May 17, 1982. See Securities Exchange Act Release No. 18713 (May 6, 1982), 47 FR 20413.

14/ "Order exposure" is basically the antithesis of internalization and contemplates the exposure of an order to other market centers, providing the opportunity for that order to be executed at a superior price in those market centers.

internalization, and advocated that an anti-internalization rule had to be in place as a precondition to implementing the linkage. 15/ Others, however, argued that the espoused dangers of internalization were unreal and unproven. 16/ These commentators further asserted that an order exposure rule of any form probably would prove too cumbersome and would destroy any efficiencies that resulted from an OTC market maker dealing with its customers on a principal basis. 17/

After thorough consideration, the Commission determined that the interface would not directly exacerbate internalization concerns as a structural matter and that development of a means of addressing concerns regarding internalization was not a prerequisite to an interface. The Commission, however, encouraged the industry to independently search for an acceptable means of addressing those concerns. In this connection, several significant industry proposals emerged. Under the auspices of the Securities Industry Association ("SIA") a special committee of OTC and exchange representatives, the so-called "DeNunzio Committee," agreed

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15/ See, e.g., Letter to George A. Fitzsimmons, Secretary, SEC, from James E. Buck, Secretary, NYSE, dated March 13, 1981.

16/ See, e.g., Letter to George A. Fitzsimmons, Secretary, SEC, from William A. Schreyer, Chairman, Merrill Lynch Pierce Fenner & Smith, Inc., dated March 6, 1981.

17/ Id.

upon certain principles that should be incorporated in a rule addressing order exposure, if it was determined that such a rule was necessary. Those principles generally would require both exchange and OTC market makers to expose their customer orders to all other market centers or market makers before executing those orders as principal. In addition, the NYSE took independent steps to formulate an order exposure measure. The exchange submitted a proposed rule to the Commission which resembled the SIA Committee's order exposure principles, but limited the rule's applicability to OTC market makers. In this respect, the NYSE argued that, because of the conflict of interest inherent in an OTC market maker trading as principal with his customer, concerns raised by the removal of off-board trading restrictions required more immediate attention. The NYSE did, however, express support for continued industry discussions regarding an order exposure rule applicable to all markets, both OTC and exchange.

In May 1982, the ITS/CAES linkage became operational on a pilot basis for 30 of the most actively traded 19c-3 Securities. Recognizing that industry initiatives toward formulating a consensus approach to order exposure had progressed as far as possible without further Commission involvement, the Commission commenced a rulemaking proceeding which proposed alternative Commission approaches to addressing order exposure.

Possible Commission Approaches to Order Exposure

Specifically, the Commission proposed three alternative approaches to addressing order exposure concerns. The first alternative would defer action on an order exposure measure until such time as action is warranted by demonstrable harm resulting from internalization.

The second alternative, based substantially on the rule proposal submitted by the NYSE, and designated as proposed Rule 11A-1[A], would impose certain restrictions on the manner in which OTC market makers in Rule 19c-3 Securities deal as principal with customer orders. 18/ Specifically, the broker-dealer would have to follow one of two alternative sets of procedures before dealing as principal.

First, the broker could expose the order to other market centers (the "order exposure" alternative) by: (i) "stopping" the total number of shares of the order (*i.e.*, guaranteeing the execution of the order) at the intended execution price; 19/

18/ "Customer" is defined in Section (e)(13) of the Rule to include, generally, (i) any person other than a broker-dealer and (ii) any person from whom an order has been accepted for execution, but only with respect to orders so accepted.

19/ In order to avoid trading through other ITS markets (*i.e.*, trading at an inferior price than available in other ITS markets), the stop price would have to be at least as good as the best price then available in any participating ITS market.

(ii) exposing the customer order at a price 1/8 better than the intended execution price for 60 seconds; and (iii) publishing a quotation at the stop price for his own account for 60 seconds, in a size equal to the customer order. After doing so, if the customer did not receive an execution at the superior price, the broker-dealer may execute the order as principal. 20/ Rule 11A-1[A] would except the broker-dealer from the requirement that he expose the customer order at a price 1/8 better if his existing published quotation represents a customer order at that price and is maintained for 60 seconds. 21/ Similarly, the broker-dealer would not have to publish a quotation for his own account at the stop

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20/ For example, assume a customer sends an order to sell 500 shares of XYZ, a 19c-3 Security, and the broker-dealer's quotation is 19 7/8 bid, 20 1/4 asked (both for 100 shares), with the inside ITS market being 20 bid, 20 1/4 asked. The broker-dealer would have to (i) stop the order at 20; (ii) offer the 500 shares for the customer at 20 1/8 (1/8 above the stop); and (iii) bid for the 500 shares at 20 as principal (the intended execution price). After publishing those quotations for 60 seconds, the broker-dealer could buy the 500 shares as principal at 20.

21/ If the quotation is for a proprietary account, the broker-dealer would have to increase the size of the quotation by the size of the customer order.

price if he already has published such a quotation and maintains that quotation for at least 60 seconds after receipt of the order. 22/

The second alternative available to the broker-dealer would be to enter the order into CAES otherwise than directing the order to himself for execution. This alternative (the "order export" alternative) also would require the broker-dealer to put in place procedures which would preclude (i) persons at the broker-dealer's firm responsible for proprietary trading in that security from having any knowledge of the customer order prior to its entry into CAES; and (ii) having persons responsible for dealing with customer orders in that security from having any knowledge of the firm's proprietary positions or trading strategy in that security (the "knowledge limitation").

The third alternative is an order exposure rule based substantially on principles developed by the SIA's special committee, and is designated Rule 11A-1[B]. Rule 11A-1[B] has been regarded as the "All Market Rule" because it would

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22/ If a broker-dealer's proprietary quotation is accepted in whole or in part by one or more third parties, and the broker-dealer subsequently revises his quotation, superseding the quotation representing the customer order, the broker-dealer is deemed to have met the hold out requirements and may execute the customer order at the stop price. For example, in the example in note 20, *supra*, if the broker-dealer's bid of 20 is accepted and the broker-dealer lowers his quotation to 19 7/8 bid, 20 asked, the broker-dealer can execute the customer's 500 share sell order at 20.

apply some of the order exposure requirements of proposed Rule 11A-1[A] to all market makers in Rule 19c-3 Securities, whether off-board or on an exchange floor. Like proposed Rule 11A-1[A], the rule would require all market makers to stop a customer order at the proposed price, and publicly to bid or offer (as the case may be) the order at 1/8 better than that price for a 60 second period, before executing the order as principal. 23/ However, the rule would not require market makers to display a principal quotation matching the proposed execution price. Proposed Rule 11A-1[B] also would contain a CAES order export alternative identical

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23/ It should be noted that, when the dealer already has outstanding a quotation at a price 1/8 superior to the intended execution price, the proposed rule provides, as an alternative to the procedure suggested by the NYSE, that the market maker need not increase the size of that quotation as long as the size of the quotation is at least that of the customer order, even if the market maker's quotation is as principal. The customer order, however, would be "deemed" to be represented by the market maker's quotation for 60 seconds after receipt of the customer order. Thus, if during that 60 second period, the market maker's quotation is executed against, the Rule would require that the customer order receive the benefit of the execution.

Rule 11A-1[B] also provides that, if the broker-dealer changes his quotation to the stop price during the 60 seconds that a customer's order is exposed either due to an execution at his quotation price or other justifiable market conditions, the broker-dealer will have satisfied his hold-out obligations and may execute his customer's order at the stop price. For example, if the broker-dealer has stopped his customer sell order at 20, and has a preexisting customer offer out-

(footnote continued)

to that contained in Rule 11A-1[A]. Furthermore, OTC agency crosses outside of CAES would be permitted in certain circumstances. 24/ In addition, this rule would provide a market maker with the CAES export alternative.

The Commission has received over two hundred comment letters on its order exposure release, including nine letters from Congress; 127 NYSE listed companies; 28 NYSE specialist firms; 44 broker-dealers; seven institutional traders; and three exchanges. The preponderance of these comments, in particular, those comments received from Congress, NYSE listed companies and NYSE specialists, generally supported the need for an order exposure rule, although most of the comment letters did not discuss the specific elements of such a rule. The NYSE's comment letter stressed the importance of an order

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(footnote continued)

standing at 20 1/8, which then is executed against in whole, the broker-dealer can lower his offer to 20, the stop price, and execute the customer's sell order at that price. Similarly, if the market moves down, and the broker-dealer wants to lower his principal offer to 20, the broker-dealer may do so, if he executes the customer order at the stop price (20), even if the customer order had not been exposed for 60 seconds.

24/ Rule 11A-1[B] would permit OTC market makers to execute agency crosses if (i) the inside ITS market has a spread greater than 1/8 and the cross is executed between those quotations, or (ii) the inside ITS market is a 1/8 spread and the cross is executed at either the bid or the offer.

exposure rule that would expose a customer's order as well as the market maker's principal interest in that order. The NYSE stated, however, that it now supports an exposure rule that would be applicable to all market markers and market centers. Comment letters submitted by the NASD, and an OTC group representing nine CAES market makers, stated that an order exposure rule is unnecessary because no significant harm as a result of internalization has been demonstrated. In particular, these commentators argued that, to date, Commission and NASD surveillance of Rule 19c-3 trading has evidenced no harm resulting from internalized trades. In addition, these commentators believed that both proposed rules are mechanically unworkable and would create inefficiencies of such magnitude as to preclude market making in the securities subject to the Rule. Moreover, these commentators singled out proposed Rule 11A-1[A] as being unfair as a result of its sole imposition of order exposure requirements on OTC market makers.

In addition, the Department of Justice ("DOJ") submitted a comment letter stating that the net benefits of an anti-internalization rule probably would not be positive, and, therefore, neither proposed rule should be adopted. DOJ did indicate that should the Commission adopt an order exposure rule, proposed Rule 11A-1[B] would be preferable because of its more limited nature and evenhanded approach.

Issues Raised by the Current Proposals

In any analysis of the ultimate solution to the order exposure problem, a number of issues must be addressed. First, as a threshold matter, the Commission must determine whether it is appropriate to adopt such a rule. Specifically, the Commission must determine the benefits of a customer's order receiving a superior execution resulting from increased order exposure in light of the inefficiencies and disincentives to market making, either exchange or OTC, that any particular rule may create. For example, it has been argued that an order exposure rule would make it both expensive and cumbersome for a firm to execute customer orders from its own account. Under this view, an order exposure requirement would impair the efficiency of in-house execution of customer orders, seriously reduce the profitability of a firm functioning as a Rule 19c-3 market maker and, therefore, reduce market makers' incentives to make competitive markets in Rule 19c-3 Securities.

Second, in analyzing the two rule proposals, it is necessary to address whether it is necessary to require a market maker to expose his own principal interest in his customer's order, thus exposing the market maker to the risk of a double execution. For example, assume the highest displayed bid and lowest displayed offer for a stock subject to the Rule, based on all markets disseminating quotations, is 20 bid and 20 1/4 ask, and market maker X currently is displaying 19 1/2 bid and 20 1/4 ask. Should X desire to execute a customer sell order (i.e., buy stock from his customer) for 500 shares at $20 per share (the best price available in any market), X must first stop the customer's order, thus guaranteeing to buy 500 shares from his customer at $20 per share, and must raise his displayed bid to $20 with an accompanying size of at least 500 shares for a minimum of 60 seconds. In addition, X must also expose his customer's offer at 20 1/8 or at 1/8 below the prevailing best systemwide offer for a minimum of 60 seconds. If during this 60 second period X's bid is hit for the entire 500 share amount and his offer on behalf of his customer is taken, X will be required to purchase 500 shares of stock at $20, at the same time he lost his customer's sale. 25/

One rationale for this approach, is the concern that if a market maker's principal interest is not exposed, it is argued that, hidden markets will, in effect, arise. In other words, if the market maker is willing to purchase

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25/ Alternatively, if X's customer's order is not taken in this example, but his principal quotation is taken, X will be required to honor his client's stop thereby purchasing 1,000 shares of stock rather that the intended 500 shares. Should this situation occur while the market was declining, X could be exposed to a risk of substantial trading losses.

(sell) a certain amount of securities at a certain price from its customer, its willingness to trade at those terms should be exposed to all market participants via displayed quotations. On the other hand, it has been argued that such a requirement would significantly impede market making and that, so long as the customer's order is exposed (with the opportunity to receive a superior price), it is unnecessary to separately require disclosure of the principal interest.

A third open issue concerns the advisability of imposing any order exposure requirement on the small order automatic execution systems operated by certain regional exchanges. Small orders routed to such systems receive automatic executions derivatively priced based on the inside ITS market. 26/ The ability of these systems to generate rapid execution reports with no potential for "questioned trades" appears to have allowed the regional exchanges to effectively compete for small order flow. The imposition of an order exposure requirement on these systems, it is argued, might cause delay of a customer's execution report if his exposed order is intercepted by another market center or market maker.

26/ Presently, the Pacific, Philadelphia and Midwest stock exchanges operate automatic execution systems; SCOREX, PACE and MAX, respectively. By contrast, the NYSE's DOT system and the Amex's PER system, while providing more rapid delivery systems for the execution of small orders, still envision manual intervention by the specialist.

To this extent, current customers might be dissuaded from routing their orders to the regionals. In addition, extensive redesign and reprogramming of these systems may be necessary to accommodate order exposure requirements. Nonetheless, it is possible that an order exposure rule placed upon these systems would be appropriate in that the one-time costs in revamping these systems, and the minimal reduction in the timeliness of execution reports, would be justifiable in light of the increased opportunities for customer orders to receive superior executions.

More general concerns regarding an order exposure rule center around whether small orders, whether or not automatically executed, and agency crosses should be excluded from order exposure initiatives. In its order exposure release, the Commission noted that in January 1982, orders of 200 shares or less accounted for 43.7% of NYSE transaction volume but only 5.1% of its share volume. These figures raise the issue of whether the requirement of exposing small orders would be unduly burdensome, as the mechanical demands of exposure would be placed upon a high percentage of transactions which would represent only a relatively small number of shares traded. Accordingly, at this time, both proposed rules would exempt small orders from order exposure requirements.

Both rules also address agency cross-transactions as a separate matter. Proposed Rule 11A-1[A] would bar all agency cross transctions arranged by OTC market makers unless the orders were routed through CAES. Exchange specialists, however, would be excluded from this prohibition. Proposed Rule 11A-1[B] would allow OTC market makers to arrange agency crosses at either the bid or ask price in an 1/8 point market, or at a price between the spread in other cases. Should an OTC market maker wish to handle an agency cross at a price away from the inside market, he would have to do so by routing its order to CAES. This Rule would not apply to trades on an exchange floor.

Finally, both Rules also currently exempt block trades, from exposure requirements, transactions involving 10,000 shares or more or a market value of $200,000 or more. In this connection, the Commission noted, in its order exposure release, that the ultimate issue with respect to block trades involves limit order protection, and currently there are other methods to protect such orders from block executions at inferior prices. Moreover, because block trades are often done at prices away from the prevailing market and usually envision an expecially quick execution, if an order exposure rule were adopted and it was determined to include block trades, it would be particularly important to design procedures which would not substantially disrupt normal block trading procedures.

CONCLUSION

The Commission currently is monitoring the impact of Rule 19c-3 in the linked trading environment. In particular, the Commission is continuing to investigate the nature and extent of potential harm caused by internalization. After analyzing the results of these investigations and with the benefit of the great wealth of public comment letters on the proposed alternatives, the Commission is preparing to take the next step in the continuing controversy surrounding order exposure.

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"Cooling off" period

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