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September 24, 1976

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

Re: In-House Agency Cross Transactions in Listed Securities by Exchange Members

Dear Sirs:

In Securities Exchange Act Release No. 11942, dated December 19, 1975, you requested the National Market Advisory Board (the "Board") to advise you of its views on the above-captioned subject not later than October 1, 1976. The Board has received submissions from, and consulted with, a number of interested persons regarding this matter, and the Board members also have discussed the subject at length at several Board meetings. Set forth below is the advice of the Board and the minority views of certain Board members.

<u>CONCLUSION</u>

The Board hereby advises you that, as a result of its consultations and discussions, a majority of the Board (eight members to four, with three members absent) recommends that the Commission should not at this time take any action to require any exchange to permit its members to engage in in-house crossing of agency orders for listed securities. [Footnote: The following members voted with the majority: Messrs. Cohen, Eshman, Fomon, Guerin, McCulley, Marron, Scanlon and Stone. The following voted with the minority: Professor Lorie, Mrs. Miller, and Messrs. Swinarton and Weeden.]

In the Board's judgment, existing exchange restrictions on in-house agency cross transactions do not impose a significant burden on competition or, to the extent that they do, such burden is outweighed by the following countervailing policy considerations related to the development of a national market system.

Permitting in-house cross transactions would allow a proliferation of market centers with a likely adverse impact on the fairness and orderliness of markets. It also would reduce the ability of bids and offers at better prices to displace others, and would weaken the value of limit order books as a mechanism for providing price and time priority for public orders. The majority believed that perhaps at some later time, when market centers were better “linked”, these adverse consequences could be avoided, but that permitting in-house cross transactions now would be a step in the opposite direction -- one with a centrifugal momentum rather than a movement towards coordinating and centralizing markets, which would be the general effect of linking them.

In addition, it is inadvisable to take such a step, which is closely related to the question of whether off-board principal transactions in listed securities by exchange members should be permitted, before that broader question is fully considered by the Commission and the Board.

DISCUSSION AND ANALYSIS

In reaching its conclusion, the Board recognized that somewhat different considerations are involved with respect to (i) block crosses and (ii) retail crosses.

Block Cross Transactions

Today blocks may be crossed on exchange floors away from the primary market for the security involved, and this is sometimes done to avoid exposing the transaction to the crowd which may exist in the primary market, as well as to the specialist there and the limit orders he holds. Today, for some, it is not economic to transport small block transactions to the non-primary exchange markets, but permitting in-house crosses would provide an economical means for those effecting small block crosses to avoid exposing such transactions to the buying or selling interest represented by the crowd, specialist, or limit orders held by the specialist. Furthermore, while today blocks may be transported to non-primary exchanges, such transactions cannot avoid a person strongly desiring to participate in the transaction by offering a higher price or willing to accept a lower one. Such person can make sure that his bid or offer is represented on all exchange floors. Permitting in-house crosses would not only allow such persons buying or selling interest to be avoided but would mean all specialists and all limit orders on all exchanges could be avoided, which is not true today. Because it is in the economic interest of the broker arranging a block cross to avoid exposing the transaction (i) to a person willing to displace at a better price (who by displacing would cause the broker to lose all or part of his order and therefore deprive himself of all or part of his commission on one side of the transaction) or (ii) to one whose offer of a better price could cause a renegotiation of the cross and thereby delay the execution of the transaction, it is likely that opportunities to avoid such exposure will be used.

While relevant buying and selling interest may usually be searched for prior to the execution of a cross, if in-house crossing is permitted, it is likely that a significant number of transactions will occur in which all of such interest has not been taken into account, particularly undisclosed interests in the crowd and indications of interest known to the specialist. Permitting in-house crosses, therefore, will weaken the structure which currently promotes the principle of price priority and facilitates better bids and offers displacing others. It would also result in increased trading away from market centers where limit orders are left without protecting the limit orders against such trading, an inadvisable step to take at a time when the Commission and the Board are considering means to enhance the protection of limit orders.

A fair and competitive pricing mechanism which ensures that all relevant buying and selling interest is taken into account in connection with each transaction should be a keystone of a National Market System, but allowing in-house crossing, with the fragmentation it entails, would be a move in the opposite direction.

Retail Cross Transactions

One or more members of the majority voted in favor of allowing continued restrictions on the theory that, because of the probable infrequency of in-house crossing, the restrictions were an insignificant burden on competition, and that exchange rules should not be abrogated by the Commission unless such rules constituted a material burden on competition. On the other hand, at least one of the minority voted against permitting continued restrictions by exchanges on the theory that the restrictions were, in view of the probable infrequency of in-house crossing, unneeded, and that unneeded regulations should be eliminated wherever possible.

The reason that there is unlikely to be significant interest in in-house retail crossing is that only a very few firms have an order flow which would merit their considering matching orders of retail size in house. [Footnote: In this regard, a question was raised as to whether the Commission intended to include within the subject of in-house crossing the question of whether a correspondent firm effecting executions for a variety of brokerage firms should be permitted to cross orders of customers of different brokerage firms and whether this would make the correspondent firm an “exchange” within the meaning of the Securities Exchange Act of 1934, as amended.] In order to have a significant number of matching orders, even such firms probably would have to build in some delay in executing orders; this, during the trading day, would give rise to the problem of missing the market. In addition, in-house crossing of retail orders would involve significant programming and development costs, as well as additional operational costs associated with notifying the consolidated tape facility of sales information with respect to each cross.

It has been suggested that in-house retail crossing during the trading day might be an attractive service to customers if it might enable some customers in some circumstances to obtain a better price for the securities they bought or sold than would otherwise be the case. For example, it is claimed that both market orders crossed in-house might receive a better price if they were crossed between the existing best bid and asked, and that in any event one order would receive a better price if the cross were executed at its side of the quotation rather than having each order executed against the opposite side of the spread. However, the following examples show that to the extent these results cannot be achieved today, they could be achieved with in-house crossing only at the cost of disadvantaging other market participants.

When the best bid and offer in a security are separated by only an eighth, the proposed in-house retail cross could take place either at the bid or the offer side of the market or at a price between the bid and the offer. If consummated at the bid or offer side, it would mean that the best pre-existing bid (or offer) in the market place could not make a claim of time priority against the buy (or sell) order being crossed. If such bid or offer in the market place were a public limit order on the book, it would mean that one member of the public was being disadvantaged to the benefit of another who happened to be a customer of a particular member firm.

Attempting to consummate in-house crosses between the spread where the spread was only an eighth would present the difficult problem of introducing a new, intermediate, unit of pricing. Furthermore, if specialists began accepting orders in such new unit, firms providing in-house crossing services would be required to reduce again the monetary unit in which they effected such crosses.

Because of the cost of changes which would have to be made to existing data processing, quotation and last sale reporting devices, if any change were to be made in the monetary unit of trading it should be made only after careful study and then on a uniform, across the board basis.

In order to avoid these problems, a member of the minority suggested that in-house retail cross transactions be permitted between the best bid and offer on limit order books, and then only when there is more than an eighth spread between such orders. This restriction probably would reduce substantially the number of orders which would be eligible for in-house retail crossing because it is just those securities in which members receive most of their retail size orders which tend to trade with the narrowest spreads. It would also require a means of disseminating the best bid and offer in limit order books, a facility currently under consideration by the Commission and the Board in connection with discussions relating to a consolidated limit order book, but one that is not yet available. In addition, this probably would not provide any better execution for a customer than he would receive today because the floor broker for a retail firm who goes to a post with matching market orders should today attempt to cross then between the best bid and offer. If the cross took place only because one of the orders was held up for a period of time, it would mean that another broker’s order brought to the floor of an exchange during that period would miss the opportunity of meeting such in-house order on the floor. Thus, permitting in-house retail crosses would lead to some orders which are brought to the floor receiving an inferior execution to that which they would receive today and inferior to the identical order which was part of the in-house cross, even though such order brought to the floor might be entitled to time priority today over such identical in-house order.

Development of Multiple Market Centers-Fragmentation

Permitting in-house cross transactions would have the effect of constituting the firms conducting such crosses as new market centers, that is, as locations where public orders (whether individual or institutional) can meet other public orders. While a variety of market centers exists today, the general movement has been to coordinate and centralize them by “linking” them. Multiplying the number of market centers would have an opposite effect. The resulting fragmentation of order flow would make existing markets less “fair and orderly.” With transactions taking place in a multiplicity of market centers it is difficult to give effect, in the overall market system, to notions of price and time priority -- ideas usually viewed as part of the concepts of fairness and orderliness.

As noted above with respect to block crosses, better bids and offers in one market place, whether entered in a limit order book or held in a crowd, may never have an opportunity to be heard in other relevant market places if in-house crosses are permitted.

Furthermore, permitting in-house crossing would require additional surveillance procedures with attendant costs.

Off-Board Principal Transactions

The issues raised by the subject of this letter are related in many ways to those raised by the question of whether off-board principal transactions in listed securities by exchange members should be permitted. Both the Commission and the Board will be considering this latter subject shortly, and permitting in-house cross transactions is a step that it would not be appropriate to take before a conclusion is reached with respect to the broader question of off-board principal transactions.

MINORITY VIEWS

The following is a brief statement of the views of the minority, some of which have been anticipated above.

Most of the members who voted with the minority were of the view that existing restrictions on in-house crossing are anti-competitive and that the alleged adverse consequences from their removal are speculative and have been exaggerated. They conclude that where exchange rules constitute a burden on competition and the adverse consequences from their abolition are speculative the rules ought to be abrogated. As already noted, at least one member of the minority was of the view that removing restrictions on in-house crossing was unlikely to affect market behavior in any material way and that unnecessary regulatory restrictions should be eliminated wherever possible.

Existing Restrictions are Anti-competitive

a. They restrict scope of upstairs market services. Prohibitions on in-house block crossing limit the nature of the services which member firms can provide to block customers and the means of reducing the costs thereof.

If such crossing were permitted, the firms could avoid the time and expense of taking transactions to the floor when they concluded this was not required in the best interest of their customers. Thus firms would be better able to compete with the various floors as upstairs market centers for listed securities. Furthermore, it is unlikely that block-cross customers would be disadvantaged as a result. The fiduciary duty of brokers and the pressures of a competitive market place would insure that any relevant buying or selling interest represented in the various market centers would be taken into consideration when cross transactions were effected in-house.

b. They disadvantage third market makers. Current restrictions on in-house crossing are also anti-competitive because they give the specialist an unfair competitive advantage over third market makers. The rules require that a planned block cross be shown to a specialist before it is executed. This insures that specialists see a certain order flow and makes it less likely that such orders will be shown to third market makers.

c. <u>They limit competition in retail services.</u> Abolishing in-house crossing restrictions with respect to retail size crosses would enable firms to develop new kinds of services which might be attractive to retail customers. It is not unlikely that a sufficient order flow would exist, or could be stimulated, after and before normal exchange trading hours in order to enable retail firms to devise and offer to customers order crossing services during such periods which would reduce customers' commission costs and yet avoid problems of "missing a market".

<u>Adverse Consequences of Abolishing Restrictions are Speculative</u>

Because sales transactions occur in a variety of places does not mean that a market is fragmented. The existence of a last sale tape, a composite quotation system and normal competitive pressures will insure that, even if transactions take place at diverse locations, the prices at which such transactions are consummated will be directly related to transactions taking place at other locations. Thus, members of the minority concluded that the probability of substantial fragmentation occurring is sufficiently remote and the restrictions on competitive behavior so clear, that it would be preferable to take this slight risk in order to enhance competition in the industry.

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The foregoing is an effort to summarize the views of both the majority and minority of the Board on the above captioned subject. As noted, the Board voted 8 to 4 to recommend that the Commission should not at this time take any action to require any exchange to permit its members to engage in in-house crossing of agency orders for listed securities.

Respectfully submitted,

NATIONAL MARKET ADVISORY BOARD

By: John J. Scanlon, Chairman