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August 15, 1977

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

Re Release No. 34-13662, File No. 4-180

Gentlemen:

As you know, I am a member of the National Market Advisory Board and my law firm is general counsel for the Chicago Board Options Exchange (among other possibly interested clients) and until recently was outside counsel for the Midwest Stock Exchange. However, I am writing in a personal capacity and not on behalf of any other person or organization.

I am writing to express my grave concern that more harm than good may result if the Commission proceeds to a general removal of restrictions on off-board trading by January 1, 1978, and to urge you to revisit some of the premises, arguments and presumptive conclusions set forth in Release No. 34-13662. I hope and believe that such further review will lead to the conclusions that—

(1) The next step in the removal of off-board trading restrictions should be limited to upstairs market-making involving dealing as principal with other professionals.

(2) Even this should not be done without effecting essential regulatory changes.

(3) The lifting of restrictions on in-house principal trades with non-professional

customers (with a possible exception for demonstrably "better than elsewhere" executions) and in-house agency crosses should be deferred at least until other essential steps toward a national market system have been accomplished.

I am aware that some of those who oppose any lifting of restrictions have vested interests to protect and/or are generally disposed to favor the status quo. I also appreciate the Commission's concern that a "double disincentive" may be created if opponents of change are encouraged to think that remaining off-board trading restrictions will not be modified until various other things have been accomplished. Nevertheless I hope that the Commission will give further heed to the expressions of concern by many knowledgeable and thoughtful persons that simply going ahead with removal of all restrictions by January 1, 1978 may seriously impair the quality of existing markets, the confidence of investors and the chances of ending up with a better market system.

Based on the various presentations in the present and prior proceedings and my own familiarity and concern with problems of market structure and off-board trading restrictions, I believe that each of the following propositions is sound and accurate (although I will not attempt to substantiate each of them within the scope of this letter) and relevant to the questions posed by Release No. 34-13662:

—That the question of lifting off-board trading restrictions, although dealt with specially in Section 11A(c)(4), must be considered in light of all the objectives of Section 11A and all the other regulatory purposes and standards of the Act.

—That removing burdens on competition is merely one of several statutory objectives that must be constantly balanced and reconciled in moving step-by-step toward a national market system; and that competition among market-makers is only one form of competition with which the Act is concerned.

—That the over-the-counter market, even as improved through NASDAQ and other developments of recent years, is far from being an adequate model for a national market system — because, among other reasons, the national market system is supposed to preserve and enhance certain basic virtues of today's listed markets which the over-the-counter market lacks.

—That shortcomings of the present listed markets — in respect of full protection of limit orders, for example — should be considered a challenge to find ways of improvement and not a justification for accepting similar, let alone greater, shortcomings in a national market system.

—That to realize the objectives of a national market system it will be essential to accomplish various electronic linkages and various regulatory changes; and that mere enhancement of competition among dealers cannot be counted on to bring these about.

—That collaboration among industry organizations, whether now or after off-board restrictions are removed, also cannot be counted on to accomplish these results unless the Commission effectively intervenes — as it has done in the past, with less clearly defined powers than now, to bring about such developments as NASDAQ, the Consolidated Tape Association and The Options Clearing Corporation.

—That some form of CLOB is a necessary linkage — along with a consolidated transaction reporting system, a consolidated quotations system and inter-market execution facilities — in an ultimate national market system.

—That essential regulatory changes include, at a minimum, "equalizing" (in the

statutory sense) regulation of competing market-makers to assure a fair field of competition; but that they may also encompass obligations of brokers and dealers, in respect of order priorities, self-dealing, best execution, etc., that greater competition cannot assure but that would be needed to carry out the objectives of a national market system.

—That all of the foregoing considerations are relevant in deciding when and how the removal of restrictions on off-board principal trading should occur, since the order in which various steps are taken may be of utmost importance in determining the ultimate shape of a national market system.

To these I would add the following propositions relating particularly to in-house retail trades, all of which propositions I also believe are basically sound and highly relevant at this time:

—That the Commission is not now faced with making a choice between (i) stopping in its tracks or (ii) proceeding to eliminate all restrictions on off-board principal trades; but rather, that the Commission can and should proceed selectively and in stages.

—That with respect to retail principal trades, overreaching is not the main problem, but that the problems of market fragmentation and impact on competition are at least equally important.

—That permitting retail principal trades under present circumstances —

(a) is likely to cause far more serious market fragmentation and to be a far greater obstacle to attainment of a national market system than would result from merely adding "upstairs" market-makers and permitting dealing with professional customers;

(b) is not likely, in net effect, to enhance competition in market-making and is likely to impair competition in other respects; and

(c) is likely to defeat other important objectives of a national market system, including preservation of public confidence in the markets.

—That even if overreaching were the only problem, the effective way to meet it would be a prohibition of retail principal trades along the lines of proposed rule 15c5-1[A]; and that if there is not a total prohibition, only "better than elsewhere" rather than "as good as elsewhere" trades should be permitted.

—That in drawing the "retail" line, or the line between professionals and non-professionals, the definition of the professional or non-"retail" category should be narrower than the definition of "financial institution" contained in the various versions of proposed rule 15c5-1 and perhaps should include size of transactions as a factor.

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I express the foregoing conclusions and supporting propositions as one who has long been an advocate of competition in the securities markets. With particular reference to the question of benefits of competition versus problems of fragmentation, I took a leading part, as Director of the Special Study of Securities Markets, in reaching the conclusion in 1963 that—

> As applied to over-the-counter trading in listed securities, it appears to the Special Study that the advantages of competition generally outweigh any concern over impairment of depth in the primary market. (Special Study, Part 2, page 908)

And again—

> As in the case of multiple markets generally, the third market requires evaluation of the advantages of competition with reference to possible impairment of the depth of the primary market. Under existing circumstances, it appears that the over-the-counter market for listed stocks has been beneficial to investors and the public interest. (id., page 910)

More recently, I joined in the unanimous conclusion of the National Market Advisory Board that —

> [O]ff-board trading restrictions are a burden on competition and . . . the purposes of the Act do not justify exchanges maintaining such restrictions generally and indefinitely. (NMAB 5/19/77 letter, pages 2-3)

But, having previously voted against removing restrictions on in-house agency crosses (NMAB 9/24/76 letter, pages 2-5), I was one who urged emphasis on "generally and indefinitely" in the above quotation and, in particular, I vigorously advocated that restrictions should not be removed as to principal trades with retail customers. (MHC memo to NMAB, 4/11/77; see also NMAB 5/19/77 letter, pages 5, 12-17) The latter remains a very serious concern on my part, but it is not a new one. Back in the Special Study, one of the conclusions was —

> The trading of market makers directly with individuals in the third market . . . appears to be negligible in amount . . . .[H]owever, expansion of this area of operation in the future contains the potential of a situation requiring regulation to safeguard the interests of investors. . . .(Special Study, Part 2, page 911)

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In sum, given all of the objectives of a national market system and of the whole 1934 Act as

amended, and in light of the several propositions set forth above, I firmly believe and strongly recommend that the next step in the removal of off-board trading restrictions — and it will be a major step both in what it will accomplish and what it will demand of the industry, the self-regulatory organizations and the Commission — should be limited to upstairs market-making involving dealing as principal with other professionals.

The lifting of restrictions on "retail" principal trades (with a possible exception for demonstrably "better than elsewhere" executions) and in-house agency crosses should be deferred at least until further essential steps toward a national market system have been accomplished. Since all or most of the important "pieces" of a national market system are ready, or could rapidly be made ready, to fall into place if the Commission will assume an active role as catalyst pursuant to its statutory authority, I believe this step-by-step approach will not result in any real delay in eliminating burdens on competition or in creating a national market system, but will assure a sounder, stronger system in the long run.

I realize that the above leaves many points to be worked out but I hope this letter will be of help in setting a sound course. If I can be of further help by elaborating on any of the foregoing, I will be pleased to hear from you.

All of the above is written with reference to stocks, as distinguished from bonds, options or other securities. Reminding you again that my firm is general counsel for the Chicago Board Options Exchange, I will merely add that the many important ways in which options and options markets differ from stocks and stock markets may well lead to somewhat different questions and answers, or at least a different time-

table, for options than for stocks, and I have not attempted to discuss any such differences in this letter.

Sincerely yours,

MHC/wpc

cc: Roberta S. Karmel
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Members of the National Market Advisory Board