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October 11, 1977

Mr. Andrew M. Klein  
Director  
Division of Market Regulation  
Securities and Exchange Commission  
500 North Capitol Street, N. W.  
Washington D. C. 20549

Dear Mr. Klein:

On May 18, 1977, your predecessor, Lee Pickard, wrote to the Board to invite our comments regarding a recently filed request of the Midwest Stock Exchange in connection with the "Central Message Switch" ("CMS") operated by the Securities Industry Automation Corporation for the New York and American Stock Exchanges. On August 8, Martin Budd wrote you that the Board would consider the matter at its August meeting. On behalf of the Board, I now wish to advise you as follows.

Since the specific subject matter of Mr. Pickard's letter appears to be in the nature of a contested proceeding in which the Commission will have to act in a

quasi-judicial capacity, it does not appear to be an appropriate matter for the Board to discuss on the specific facts. [Footnote: One member, Mr. Stone, dissented from this view and the general approach taken by the rest of the Board. It was his view that the CMS is a cost effective innovation owned and designed by certain marketplaces whose confiscation and nationalized sharing by others without consent of the owner-designers is incompatible with the American business system. He believed the Board and the Commission should not be a party to what he viewed as an anti-competitive effort of the Midwest Stock Exchange.]

The balance of this letter is therefore confined to our recommendations as to general principles that should apply in circumstances broadly similar to those presented, without attempting to say how the specific controversy should be resolved in light of these principles and without suggesting that CNS does, or does not, parallel the examples employed.

First, there ought to be encouragement of innovations in the securities industry, including the taking of risks and the expenditure of resources for research and development. Neither the fact that the industry is regulated nor the fact that many facilities have to be industry-wide, as discussed below, should be a reason for not encouraging innovation. Encouraging innovation means that the innovator should be able to get and retain the economic benefits of innovation.

Second, there must be reconciled with the foregoing considerations the important practical considerations that some needed industry facilities are natural monopolies. If there is a need for a composite trade reporting system, a composite quotation system, a composite limit order book, a single entity as issuer of fungible securities (as in the case of The Options Clearing Corporation), an industry wide communications system, or a neutral switching system, and it is deemed contrary to the public interest to have duplicative facilities, then regardless of where innovations occur, there must be ways of making the facilities available to industry-wide use. (This is without prejudice to the Possibility of competing “vendors” for the dissemination of industry-wide quotations, transactions reports, etc.)

Third, the Board recognizes that it may often be difficult to decide whether an existing facility created by a self-regulatory organization should be made into an industry-wide facility. For example, should the options clearing entity created by the Chicago Board Options Exchange have been regarded in the past, or should the “DOT” system created by the New York Stock Exchange be regarded in the future, as a mode of competition that ought to be protected for the innovator rather than as the type of facility that needs to be made generally available if there is to be a market “system”? This kind of question certainly merits a full opportunity for hearing not only on the part of the innovator and its competitors but also on the part of other persons having an interest in the outcome.

Fourth, where the Commission determines after hearing from interested persons, that (a) an industry-wide facility is essential and (b) there is in existence a facility created by a self-regulatory organization that can and should serve as the basis of the needed industry-wide facility, then the Commission should bend its efforts toward (i) turning the existing facility into an industry-wide facility and (ii) getting appropriate compensation to the originating self-regulatory organization so as to give fair recognition to its innovative efforts, the risks that it took and the value of what is being turned over. [Footnote: The Board appreciates that it is often difficult to quantify as a dollar amount the competitive advantage a specific facility may give the entity which developed it. Thus, in many cases, a set amount may not be able to fully compensate the innovator for the taking of its competitive advantage. In light of this fact, and the emphasis in the Exchange Act on the promotion of fair competition, at least one member, Mr. McCulley, was of the view that only in the most extreme circumstances should the Commission exercise its power to require that privately developed facilities be made available to competitors.] (When appropriate, provision for payments to the originator may be provided from future revenues of the facility.) In most instances, as when the Consolidated Tape Association and the Options Clearing Corporation were created, the result can probably be achieved by agreement of the parties if the Commission participates actively and affirmatively. Where this is not sufficient, the Commission probably has ample authority under various sections of the Act to issue rules or orders that will bring about the result.

In summary, it is clear that, in the thinking of Congress, various kinds of electronic “linkages” are essential for the creation of a national market system. By their nature, many types of needed linkages must be unified or integrated rather than duplicated. At the same time, it is essential to encourage dynamism and enterprise in an increasingly competitive industry and this means (among other things) that the normal rewards of invention and risk-taking must not be stripped away. To reconcile these two major objectives in appropriate cases, the innovations must be made available industry-wide but the innovator must be appropriately compensated for being compelled to share the innovation.

Sincerely yours,

John J. Scanlon  
Chairman