

*off Board*

M E M O R A N D U M

TO: Chairman Williams  
Commissioner Loomis  
Commissioner Evans  
Commissioner Pollack  
Commissioner Karmel

FROM: Division of Market Regulation

SUBJECT: Proposed Rule 19c-3

DATE: December 11, 1979

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OFFICE OF THE COMMISSIONER

Attached for your review are two briefing papers prepared by the Division at the request of the Chairman with respect to Rule 19c-3. The first paper reviews the issues raised in connection with the Rule 19c-3 Proceeding and summarizes the views of commentators with respect to each issue. The second paper presents the Division's analysis with respect to the most significant concerns raised by commentators.

After discussions with the Chairman, we propose to recommend adoption of the Rule with coverage being limited to reported securities (in order to limit overreaching possibilities and help assure pricing efficiency). We are beginning to draft an adopting release and would appreciate receiving views from individual Commissioners regarding the content of that release.

Our current thinking is that the release would justify adoption of the rule on two independent grounds. First, as discussed in the proposing release, the rule would limit the anti-competitive effects of off-board trading restrictions to those securities which are currently exchange traded. Thus, pending a final determination on Rule 19c-2, the rule would retain the status quo with respect to the application of off-board trading restrictions by preventing those restrictions from applying to newly-listed reported securities. Second, while we would not expect the rule to yield any empirical data which would direct further action on Rule 19c-2, the release would indicate the Commission's belief that the

rule might provide a useful learning experience to the Commission and industry without, in light of the Rule's extremely limited scope, presenting significant or irreparable down-side risks. \_\_\_/

Notwithstanding a decision to adopt the rule, we believe the release should indicate the limited precedential impact of proposed Rule 19c-3. First, while the experiential aspects of the rule are an important factor in the Commission's decision to proceed, because of the fact that the rule is not expected to yield results which are valid as a statistical model or controlled experiment, it is important to avoid placing too great an emphasis on the significance or predictive value of the information received. For example, while Rule 19c-3 may provide the Commission with useful information regarding the activities of market makers in an environment free of off-board trading restrictions and should aid in evaluating whether additional Commission regulatory action is needed to ensure appropriate regulation of market professionals situated in differing trading arenas, Rule 19c-3 should not be viewed either as a "first step" which, absent significant negative results, would inexorably lead to the adoption of Rule 19c-2 or, on the other hand, as an indication that the Commission will defer taking action on Rule 19c-2 pending reaching conclusions based on the data derived from Rule 19c-3.

Second, while a Commission determination to adopt the rule indicates a finding that the positive effects of adoption in terms of eliminating anti-competitive barriers and promoting competition outweigh any possible negative effects on the markets (particularly in view of the limited extent of the proposal), this conclusion should in no way be construed as indicating that the Commission has resolved the many difficult issues raised by commentators in connection with this proposal and with respect to off-board trading restrictions generally. For example, we believe the Commission should indicate that it continues to be concerned over problems associated with internalization and overreaching and intends to carefully monitor the extent to which these activities occur after adoption of the rule. However, because, as noted in the ITS and CSE extension orders, internalization arises in a number of contexts,

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\_\_\_/ Our second briefing memo describes certain of the ways in which the rule might provide valuable experience.

we believe the Commission should also indicate its determination to continue to analyze this issue on a generic basis. With respect to overreaching, we believe the Commission should indicate that, although it is not adopting any prophylactic rule at this time to deal with possible overreaching (such as the four overreaching rules proposed in connection with Rule 19c-2), the Commission will take corrective action if overreaching materializes or if the NASD does not make an adequate showing that it is surveilling for this activity and can affirmatively state that it is not occurring. Similarly, we believe the Commission should indicate that its decision to adopt Rule 19c-3 without additional rules to assure equal regulation and the maintenance of a fair field of competition should not be construed as a decision that such rules would not be appropriate as the national market system evolves. To the contrary, we believe the Commission should indicate that it expects to actively assess the efficacy of the current regulatory structure and need for additional affirmative or negative obligations as the national market system evolves.

We would hope to receive any views you may have regarding the content of the draft release in the next week.