William M. Batten
Chairman and
Chief Executive Officer

July 23, 1982

Chairman John S. R. Shad
Commissioner John R. Evans
Commissioner Barbara S. Thomas
Commissioner Bevis Longstreth
Securities and Exchange Commission
450 5th Street
Washington, D.C. 20549

Re: Securities Exchange Act Release No. 34-18738
(File No. S7-930)

Dear Chairman and Commissioners:

The New York Stock Exchange is pleased to respond to the Commission's invitation to comment on the need for an order exposure rule in connection with the exemption of certain exchange-listed stocks from exchange off-board trading rules under SEC Rule 19c-3.

The Commission is aware of the Exchange's long-standing belief that an effective order exposure rule must be adopted as an essential element of the experimental linkage between the Intermarket Trading System (ITS) and the Computer Assisted Execution System (CAES) operated by the National Association of Securities Dealers.

In the Securities Acts Amendments of 1975, Congress sought to eliminate the basic problem of market fragmentation through the development of a National Market System for listed stocks. However, by adopting Rule 19c-3, which permits stock exchange member firms to act as market-makers in newly listed stocks outside the exchange markets, the Commission has exacerbated market fragmentation problems and created conditions which are fundamentally incompatible with the National Market System envisioned by Congress.

Those conditions include unfair competition among market-makers, increased fragmentation of the markets for stocks subject to Rule 19c-3, and a significant reduction in the opportunity for customers' orders in those stocks to meet one another directly, without the intervention of any dealer. They cannot be corrected by merely linking off-board market-makers in Rule 19c-3 stocks with the previously interlinked exchange markets, as the Commission has mandated -- even with trade-through rules in place. In order to lend validity to any continuing experiment and to permit evaluation under conditions consistent with the objectives of the system Congress called for, it is essential for the Commission to adopt an order exposure rule for Rule 19c-3 stocks, as promptly as possible. The most harmful kind of market fragmentation occurs when dealers execute "captive" customer orders in a manner that insulates those orders from interacting with other competing buying and selling interests. Since that practice negatively influences all markets to a greater or lesser degree, an order exposure rule should apply to all markets and market-makers.

A properly designed rule will enhance competition, systemwide --both for and among orders-- and assure all buyers and sellers of listed stocks a fair opportunity to obtain the best prices available, systemwide, at any given moment. We believe the experiment should continue for six months, with a rule in place, subject to uniform, accurate monitoring across all markets. The results should then be carefully analyzed before determining any subsequent course of action.

We plan to submit a separate filing, by early August, commenting specifically on the alternative order exposure rules proposed by the Commission in Release No. 34-18738, and we plan to suggest modifications to the all-markets rule proposed in the release.

We are also preparing supplementary comments on the monitoring of Rule 19c-3 trading to date, and the Commission's interpretation of the data collected. We will forward those additional comments to the Commission within the next few weeks.

<u>BACKGROUND OF THE ISSUE</u>

In the Securities Acts Amendments of 1975, Congress stated that "the securities markets are an important national asset which must be preserved and strengthened." Congress called for a National Market System that, among other things, would link the various markets in which listed stocks are traded in a system that would employ modern technology to extend, systemwide, the public benefits and investor protections historically associated with exchange auction trading principles and exchange market procedures.

The system Congress envisioned would assure "fair competition" among brokers and dealers, and among markets. It would strengthen the ability of brokers to execute customers' orders in the "best market." And it would promote competition among orders by unifying total order flow to overcome the widely acknowledged undesirable consequences of market fragmentation. Thus, the National Market System would enhance the opportunity for investors' orders in listed stocks to meet and interact directly, "without the participation of a dealer."

In shaping the 1975 legislation, Congress repeatedly stressed the importance of bringing all the markets together. For example, the Senate Committee on Banking, Housing and Urban Affairs cited as a paramount objective:

> "...the centralization of all buying and selling interest [in a given stock] so that each investor will have the opportunity for the best possible execution of his order, regardless of where in the system it originates."

Similarly, the House Committee on Interstate and Foreign Commerce insisted that investors must be assured that the system:

> "...maximizes the opportunities for the most willing [seller] to meet the most willing buyer."

In effect, Congress said that modern communications technology should extend the benefits associated with the exchange agency auction markets across <u>all</u> markets for listed stocks -- to the benefit of <u>all</u> public investors. A key step toward that goal would be to unify order flow by linking the existing markets. A properly structured linkage, with appropriate rules and procedures, would promote, first, direct interaction and competition among customers' orders to buy and sell listed stocks, without unnecessary dealer intervention and, second, fair competition among market-makers whenever their participation might be needed to assure the maintenance of fair and orderly markets.

It is important, in this context, to note that Congress, recognizing that stocks vary widely with respect to trading volume, price, number of stockholders and so on, intended all stocks to trade in the manner most appropriate to their individual characteristics. Essentially, this means that all stocks that are listed on exchanges should trade in accordance with auction agency trading principles. But it does not mean that auction agency trading procedures are necessarily appropriate for all stocks. Dealer markets can and do provide the most appropriate trading environment and procedures for thousands of stocks -- and nothing in these comments should be construed as suggesting that dealer markets in those stocks should not continue to perform their normal, useful function.

PROGRESS TOWARD A NATIONAL MARKET SYSTEM

Congress did not attempt to design a National Market System or to impose one on the securities industry. Rather, Congress directed the Commission and the industry to work together to identify and create the components needed to meet the objectives specified in the 1975 Amendments. The New York Stock Exchange has consistently supported the Congressional concept of a National Market System and continues to work closely with the other self-regulatory organizations --and with the Commission-- to achieve those objectives.

The development of a National Market System has proceeded in an evolutionary, rather than a revolutionary, manner -- a concept supported by every Chairman of the SEC since 1975. Former Chairman Harold M. Williams summarized the appropriate roles of the securities industry and the Commission this way:

"The Congress expected that the securities industry would assume primary responsibility for the design and development of the technical components of the system. The Commission's role in this process is to monitor progress, to act as a catalyst and, when necessary, to take regulatory action to achieve a particular goal or eliminate unnecessary or inappropriate barriers to competition."

The key components of the National Market System, in the sequence in which they have become fully operational, are:

- The Consolidated Last-Sale Reporting System ("Consolidated Tape") for reporting, nationwide, on a real-time basis, trades in all common stocks listed on the New York and American Stock Exchanges --and in many regionally listed issues-- wherever they may occur;
- The Composite Quotation System that displays, nationwide, the prices currently bid and offered on any exchange --and in the over-the-counter markets for the same stocks-- and the number of shares sought or offered at those prices;
- A National Clearance and Settlement System that provides fast, accurate after-trade processing for brokers and dealers in the clearing organization of their choice; and
- The Intermarket Trading System (ITS) that electronically links the American, Boston, Cincinnati, Midwest, New York, Pacific and Philadelphia Stock Exchanges, in a manner consistent with the characteristics, guidelines and objectives set by Congress.

As the Commission is aware, the New York Stock Exchange has supported the concept of electronically linking the exchange markets, and has played a leadership role both in developing ITS and in encouraging all participants to maximize their use of the system.

ITS is, in fact, widely regarded as the central component of the evolving National Market System for listed stocks. The inter-linked network has greatly increased competition for and among orders by enabling a professional on any of the seven participating exchanges to obtain for a customer a near-instantaneous execution on another exchange whenever the Composite Quotation System shows that a better price is available there.

In its June 1982 Report On The Operation Of The Intermarket Trading System: 1978-1981, the Commission noted that ITS activity has increased substantially from modest beginnings in 1978. Volume in 1981 advanced to 543 million shares. As the report further noted, the findings:

> "...indicate that the ITS is being utilized more frequently to execute trades in ITS stocks and that the growth in ITS trading is not due merely to an expansion in the number of eligible securities."

LINKING DISPARATE MARKETS

The most difficult task to date has been to find a way to integrate the exchange and over-the-counter markets in listed stocks, consistent with the Congressional goal of reducing market fragmentation. The exchange markets are essentially markets in which customer can meet customer, through broker-agents, without the intervention of a dealer. By contrast, the over-the-counter markets comprise many separate dealer markets in which customers sell to and buy from the dealer, rarely having an opportunity to meet one another directly.

Historically, the two types of markets have had entirely different pricing and trading characteristics, as well as different types of compensation. They have also operated under entirely different sets of rules.

For example, when a specialist on the New York Stock Exchange floor trades, for his own account, a listed stock in which he is registered, he is required --by rule-- to give priority to his customers' orders. As the Senate Banking Committee noted with approval, the effect

> "...is to guarantee that public orders (or members' orders originated from off-the-floor) placed with a specialist are executed ahead of the specialist's own bid (or offer) at that price as well as ahead of the bid (or offer) of any other member trading on the floor."

Obviously, this concept, which minimizes the participation of the exchange market-maker, has no counterpart in a dealer market in which the dealer participates in virtually every trade.

The opportunity for broker-agents to meet and directly represent their respective customers' interests in seeking a better execution is the prime characteristic of exchange auction markets and has no off-board parallel. This key characteristic squarely meets the Congressional objective of assuring an opportunity "for investors' orders to be executed without the participation of a dealer."

These are only some of the fundamental differences between exchange and over-the-counter markets which intensify the difficulties of integrating off-board market-makers into the National Market System for listed stocks in a manner that does not conflict with the guidelines set by Congress.

Nevertheless, the New York Stock Exchange supports the concept of bringing into the National Market System any qualified off-board market-maker who is willing to risk capital in making markets in listed stocks. Indeed, we support any constructive effort to increase both market-making capacity and competition among exchange and off-board market-makers -- so long as such measures result in fair competition and do not negate or abridge the fundamental public investor protections inherent in exchange auction market trading principles.

THE ITS/CAES LINKAGE

It follows that the NYSE supports the concept of the experimental linkage between ITS and CAES, the automated dealer trading system operated by the NASD, in 30 listed stocks in which SEC Rule 19c-3 permits exchange member firms to make dealer markets away from any exchange trading floor. But we believe the manner in which that linkage was implemented on May 17, 1982, is inconsistent with both the intent of Congress and the public interest.

As presently constituted --in the absence of an effective order exposure rule-- the ITS/CAES linkage, by itself, does not reduce the impact of market fragmentation and has the potential for increasing it. Indeed, the most harmful kind of fragmentation will continue so long as market-makers in any market are permitted, without restriction, to execute orders they control in Rule 19c-3 stocks --their own customers' orders-- without first exposing them in all other markets. This practice is detrimental to investors' interests and directly contravenes the Congressional objectives for a National Market System.

At present, an off-board market-maker in any of the listed stocks affected by Rule 19c-3 is permitted to withhold his customers' orders in those stocks from interacting with whatever buying and selling interest may concurrently exist in any other market center -- and to execute those orders, as principal, in-house, at his price. Each such execution contributes in four ways to fragmenting the market for the listed stock being traded:

First, by precluding an opportunity for orders held by broker-agents for other customers in other markets in the interlinked system to be executed against the withheld order;

Second, by denying the withheld order a meaningful opportunity to obtain a better price than the dealer is offering;

Third, by precluding other market-makers from competing for the withheld orders by bidding or offering better prices; and

Fourth, to the extent such withheld orders are executed at prices the off-board market-maker fails to expose to other markets, by preventing orders held by broker-agents in those other markets and other buying and selling interest in those markets from interacting with that market-maker at those prices.

It should be self-evident that while the law specifies an opportunity "for investors' orders to be executed without the participation of a dealer," and "in the best market," Rule 19c-3 --in the absence of any other regulation-- actually limits such opportunities. The ITS/CAES linkage experiment alone, even with trade-through rules in place, does not and cannot correct the problem. The experiment today enables and, indeed, encourages off-board market-makers to trade, as principal, against their "captive" orders in Rule 19c-3 stocks --to which other brokers, dealers and investors are denied access-- whenever they wish. The experiment imposes no obligation or compelling incentive for an off-board market-maker to seek out the best price for his customer's order, nor does it assure the customer that the off-board execution he received was, in fact, the best available in the interlinked system.

The exchange auction markets provide a striking contrast. During 1981, for example, the New York Stock Exchange published nearly 6.2 million quotations, about 20% of which had the minimum spread of 1/8-point between the bid and offered prices. Approximately 38.5% of all transactions that occurred when the spread was more than 1/8-point were executed "between the quote."

In effect, customers participating in more than 2.8 million, or 24%, of the 11.7 million individual trades on the Exchange in 1981 obtained better prices than were being quoted when they entered their orders -- because their broker-agents were able to obtain such better prices either from other brokers or from the Exchange specialist in the continuous two-way auction market.

Moreover, even when the spread between the quotes published by the Exchange is only 1/8-point, the bid or offer --or both-- most frequently represents the interest of a public customer, rather than the Exchange specialist. Obviously, in all these instances, an execution in the Exchange market meets the Congressional objective of enhancing the opportunity for customer to meet customer directly, without the intervention of a dealer.

These facts clearly demonstrate the serious fallacy inherent in the popular exercise of equating the best published quote with "best price."

<u>The published quote often is not the best price</u>, since it does not reflect the full measure of supply and demand that exists, systemwide, at any given moment. Continuous interaction among broker-agents representing customers' orders in an exchange marketplace frequently produces a better price than the best published quote. Today, when a customer deals with an off-board market-maker in listed stocks, he has no opportunity to obtain such a better price if it is available. That customer simply buys or sells at the price quoted by the market-maker; and since his order is not exposed to the concurrent buying and selling interests in other markets, he has no way of knowing whether he could have obtained a better price.

It is inherently inimical to the Congressional objectives for a National Market System for listed stocks to permit off-board market-makers in listed stocks to trade, as principal, against the orders of their own customers --who have none of the protections associated with representation by an independent broker-agent at the time such trades are consummated-- without first exposing those orders to the buying and selling interests of other market participants in other market centers.

To the extent off-board market-makers withhold "captive" customers' orders for execution in-house, without exposing them to any other market, the concept of fair competition --among orders, among brokers and dealers, and between exchange and non-exchange markets-- is clearly violated. We would not characterize any trading system for listed stocks, on or off an exchange, that permits market-makers to engage in such practices --experimentally or otherwise-- as enhancing fair competition or promoting the other basic objectives of the National Market System required by the 1975 Securities Acts Amendments.

In this context, it should be obvious that the data collected in the pre-linkage effort to monitor off-board trading in Rule 19c-3 stocks --and any conclusions which might be drawn from analyzing those data-- are not germane to the question of whether an order exposure rule is necessary at this time.

As we have pointed out, the practice whereby an off-board market-maker in a listed stock executes his own customers' orders in that stock "in-house," as principal, without first exposing them to the full flow of orders in other markets, is inherently inconsistent with the Congressional objectives for a National Market System. That fact alone requires an appropriate regulatory response by the Commission to that practice.

Moreover, we do not believe it is possible to gather statistics, however informative, to show conclusively whether an execution at a better price would have been obtained for a customer if a bid or offer on his behalf had been made throughout the interlinked system at a price between the best offer and bid then being displayed within the system.

Clearly, the <u>only</u> means of assuring best execution of a customer's order is to attempt to obtain it, by exposing the order to all other markets, thereby giving it an <u>opportunity</u> to get a better price. As noted earlier, 2.8 million trades on the New York Stock Exchange alone were executed <u>between</u> the published bid and offered prices --to the participating customers' benefit-- in 1981.

For these reasons, the data included in the Commission's August 1981 Monitoring Report On The Operation And Effects Of Rule 19c-3 cannot be used to justify failure to adopt an order exposure rule. The Monitoring Report does not show that the experimental rule has produced any beneficial results --through enhanced market-making competition or otherwise-- that outweigh the serious adverse consequences of market fragmentation and of permitting off-board principal execution of customers' orders by market-makers without first requiring system-wide exposure of those orders. It does show, vividly, that the experiment has increased fragmentation in the markets for Rule 19c-3 stocks -- since off-board market-makers are making significant use of the special competitive advantages the Rule 19c-3 experiment offers them.

In our separate filing, we will comment in greater detail on the specific deficiencies both in the data included in the Monitoring Report and in the interpretation of those data -- as well as on the difficulties and conclusiveness of trying to monitor the present experiment.

THE IMPORTANCE OF ORDER EXPOSURE

The market fragmentation problems that have been compounded by Rule 19c-3 cannot be resolved by the ITS/CAES linkage alone, even with trade-through rules in place. The linkage must be accompanied by regulation that precludes trading practices that are fundamentally inconsistent with the objectives Congress established for a National Market System.

To achieve those objectives, we believe that all market-makers in Rule 19c-3 stocks, both on and off exchanges, should be required to expose customers' orders which they control to the total order flow within the interlinked markets for possible execution at a better price --and, similarly, to expose the prices at which they propose to deal with such orders to that total flow-- before being permitted to trade against such orders as principal.

An order exposure rule should resolve the critical question of how market-makers in listed stocks should be permitted to trade, as principal, with their captive order flow. We believe such a rule must have two essential characteristics which we will discuss in detail in our supplementary comments:

- It should require every market-maker, including exchange specialists --before trading a listed stock, as principal, with a customer whose order he controls-- to expose that order to all other markets in the National Market System, thereby giving the customer an opportunity to obtain a better price than the market-maker himself is willing to provide.

- Since true competition among market-makers demands the publication of bids and offers by all competitors, and because proper operation of an order exposure rule depends upon exposure of market-makers' proprietary bids and offers at the prices they propose to make available to customers, the rule should preclude the maintenance of "hidden" or "private" markets in listed stocks by requiring each market-maker within the National Market System to make available, systemwide, the prices --with size-- at which he is willing to trade. Access to all markets, for all investors, is central to the fundamental concept of a National Market System.

We believe an order exposure rule with these characteristics must be adopted as soon as possible to assure that the experimental integration of off-board market-makers in listed stocks into the National Market System proceeds under auction agency trading principles -- and within the guidelines that Congress so clearly and specifically intended to establish for the fundamental characteristics of a National Market System.

Congress recognized that a measure of regulation would be needed to assure that the National Market System for listed stocks would exhibit the characteristics envisioned for it. The Senate Banking Committee made this clear when it pointed out that:

> "...to eliminate market fragmentation and thus to achieve a true National Market System, a set of trading rules and procedures must be adopted which will tie the individual market centers together."

While adoption of an order exposure rule is the action most urgently required to legitimatize the experimental integration of off-board market-makers in listed stocks into the National Market System environment, and to combat the pressures that tend to increase the most dangerous form of market fragmentation, it is by no means the only measure needed to assure fair competition among --and equal regulation of-- National Market System participants.

Among other critical issues that need to be resolved is the question of tape prints. At present, off-board market-makers, unlike other National Market System participants, are permitted to --and usually do-- confirm their principal trades with customers at prices that are different from the prices they report to the Consolidated Tape.

And while this may not be the appropriate place to examine in detail the unfair competitive advantages inherent in that practice --and how it can disadvantage and confuse customers and investors generally-- we strongly urge the Commission to eliminate the practice during any further experiment in off-board market-making in listed stocks.

Finally, we should stress that although adoption of an order exposure rule is the sine qua non for continuing the current experiment, it will not automatically validate the experiment. The crucial importance of an order exposure rule lies in the fact that it should provide a more realistic basis on which to evaluate the experiment. Ultimately, it will be appropriate to re-examine the validity of Rule 19c-3 itself, to determine whether that rule is, in fact, consistent with the National Market System objectives set by Congress.

In summing up those objectives, the House Interstate and Foreign Commerce Committee stressed the need to:

> "...impose the principles of competition in which all buying and selling interests are able to participate and be represented. The objective is to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations of practices and services."

The Senate Banking Committee went a step further, deploring:

> "...the lack of a mechanism in which all buying and selling [interests] in a given security can be centralized and thus assure public investors best execution,"

and adding that:

> "Until such centralization is accomplished, the protections and benefits of the auction market will remain limited."

The current experiment in off-board market-making in listed stocks disregards the intent of Congress by promoting an environment in which the opportunity for all buying and selling interests to participate is minimized, rather than maximized, and in which investors are denied the protections and benefits of auction market trading.

There are several ways in which the Commission can comply with the intent of Congress. One is to reexamine exchange off-board trading rules and reconsider whether they are, in fact, both necessary and appropriate to further the purposes of the Securities Exchange Act of 1934. In this connection, the linking of all markets in listed stocks, as required by Congress, might be better accomplished by enabling off-board market-makers to trade listed stocks through exchanges and under exchange rules and procedures. But if the current Rule 19c-3 experiment is to continue, Congressional intent demands that the Commission adopt, as promptly as possible, an all-market order exposure rule that will assure that trading in stocks covered by that rule is conducted in a manner consistent with the essential National Market System characteristics stipulated by the 1975 Amendments.

SUMMARY AND CONCLUSIONS

The New York Stock Exchange believes that the overriding purpose of a National Market System for listed stocks is to enhance the quality and effectiveness of the U.S. capital markets.

To achieve that purpose, it is essential to maintain a market structure that effectively assures fair competition among all brokers and dealers, open access to order flow for all, and the freedom of any investor --large or small-- to choose the broker or dealer best able to meet his investment service needs.

The exchange auction agency markets provide those assurances by giving all member organizations, large and small alike, access to the order flow of all. Large "retail" firms need access to the order flow generated by other large firms in order to provide their own customers with high-quality executions. Similarly, well-managed smaller firms must have access to total order flow if they are to meet the needs of the individual and institutional investors who look to them for specialized services. Institutional or "wholesale" firms need access to the aggregated order flow in acquiring and liquidating institutional customers' large positions in listed stocks. Open access to total order flow is the essential ingredient that gives the secondary markets for listed stocks their extraordinary variety and diversity.

The New York Stock Exchange firmly believes that Congress, in calling upon the securities industry and the Commission to bring a National Market System for listed stocks into existence, intended to enhance the structure of the securities markets in ways that would:

- Eliminate fragmentation of the markets for listed stocks;
- Assure fair competition both for and among orders to buy and sell listed stocks;
- Promote the best interests of investors, and assure to every investor the protections associated with exchange auction agency markets; and

• Maximize the opportunity for investors to obtain the best price available in the system at any given moment.

Over-all, Congress clearly intended to preserve and strengthen the economic viability of both the exchange and the over-the-counter markets, and to ensure their continuing ability to perform their respective important roles in the capital-raising process that is the fundamental underlying strength of the American economy.

These concepts are inherent in the National Market System objectives so carefully delineated by Congress in the Securities Acts Amendments of 1975 -- and in the Congressional call for the securities industry and the SEC to work together to bring a National Market System into existence.

The Rule 19c-3/linkage experiment has brought us to a major crossroads in the evolution of the National Market System. Prompt resolution of the attendant issues is crucial to further progress --and to the pace of progress-- in achieving the objectives identified by Congress, and to our continuing ability to maintain strong, effective capital markets in this country.

Therefore, if the experiment is to continue, we urge the Commission to adopt, as soon as possible, an order exposure rule applicable to all market-makers in stocks traded through the ITS/CAES linkage. Once that is done, we believe the experiment should continue for six months. During that period, trading through the linkage and the operation of the rule --as well as off-board trading in listed stocks generally-- should be uniformly monitored in all markets. At the end of the six-month period, the Commission --and the industry-- should carefully evaluate the results of the experiment before determining any appropriate next steps.

We hope our comments will contribute constructively to the Commission's deliberations, and we will welcome an opportunity to discuss them further if the Commission believes that may be helpful.

Very truly yours,

WmBatten