STRUCTURE of the SECURITIES MARKETS

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As a result of economic demands, technological innovation, industry initiative and regulatory requirements, the structure of this country's securities markets continue to evolve. While the most significant changes have occurred in the markets for listed securities, changes also have occurred in the markets for securities traded solely over-the-counter ("OTC"), and entirely new markets, such as the markets for standardized options on securities, have developed. In analyzing these issues it appears useful first to examine the status of several National Market System initiatives; this is followed by a discussion of potential developments in the securities markets for the balance of the decade. Finally, questions are addressed concerning the effect of emerging financial products on capital formation, and the broader question of the Commission's role in the capital formation process.

I. Status of the National Market System

A. Rule 19c-3 and Order Exposure

In 1975 Congress specifically directed the Commission to examine exchange off-board trading restrictions, (*i.e.*, exchange rules which prevent exchange member firms from effecting transactions in listed securities other than on an exchange) and to remove off-board trading restrictions that have anti-competitive effects not otherwise justified by the goals or purposes of the Securities Exchange Act of 1934 ("Act"). 1/

1/ Section 11A(c)(4)(A) of the Act.

Pursuant to the Congressional directive, the Commission carefully examined off-board trading restrictions, and concluded that these restrictions were indeed anti-competitive and inhibited market making in listed securities. 2/ The Commission also recognized, however, that the elimination of off-board trading restrictions with respect to principal transactions involved potential risks of internalization 3/ of retail order flow by member firms of the primary exchange, which in turn raised fair competition, market fragmentation and fiduciary concerns. Consequently, the Commission has proceeded with caution in addressing off-board principal restrictions.

During the following four years, the Commission instituted three separate proceedings which considered the full or partial abrogation of these rules. 4/ At the conclusion of the most

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2/ Securities Exchange Act Release No. 11628 (September 2, 1975), 40 FR 41808.

3/ The Commission has defined the term "internalization" as referring to "the withholding of retail orders from other market centers, for the purpose of executing them in-house, as principal, without exposing those orders to buying and selling interest in those other market centers." See Securities Exchange Act Release No. 16388 (June 11, 1980), at 18 n.31, 45 FR 41125, 41128 n.31.

4/ Securities Exchange Act Release No. 11942 (December 9, 1975), 41 FR 4507 (Adoption of Rule 19c-1 which removed off-board agency restrictions); Securities

(footnote continued)

recent of these proceedings, in June of 1980, the Commission adopted Rule 19c-3 under the Act, precluding the application of off-board principal restrictions with respect to certain securities newly-listed on an exchange. As a result, for the first time broker-dealer firms now are permitted to make markets in 19c-3 Securities in direct competition with exchange specialists, even though those firms also are members of the New York ("NYSE") or American Stock Exchange ("AMEX").

At the same time Rule 19c-3 was adopted, the Commission recognized that effective competition for order flow would be impaired unless an efficient inter-market linkage (linking the exchange and OTC markets) was developed. Without such a linkage, OTC and exchange market makers would have difficulty in executing their customers' orders in the best market if orders could not be efficiently routed to that market. Moreover, OTC market makers would have little ability to interact with the vast majority of retail orders which are routed to the primary

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(footnote continued)

Exchange Act Release No. 13662 (June 23, 1977), 42 FR 33510 (Proposed Rule 19c-2, which would have removed all off-board principal restrictions, ultimately was withdrawn; Securities Exchange Act Release No. 16889 (June 11, 1980), 45 FR 41156); Securities Exchange Act Release No. 16888 (June 11, 1980), 45 FR 41125 (Adoption of Rule 19c-3 which removes off-board principal restrictions for certain securities listed on an exchange after April 26, 1979).

exchange markets or to attract additional order flow through their displayed quotations. Accordingly, the Commission, in April of 1981, ordered the implementation of an automated interface between the Computer Assisted Execution System ("CAES") operated by the National Association of Securities Dealers, Inc. ("NASD") (representing the OTC market makers) 5/ and the Intermarket Trading System ("ITS") 6/ operated by seven national stock exchanges.

In the context of the linkage order, internalization concerns continued to be a focal point of discussion. After thorough consideration, the Commission determined that the interface would not directly exacerbate internalization concerns as a structural matter and that development of a means of addressing concerns regarding internalization should not delay implementation of the interface. The Commission, however, encouraged the industry to search independently for an acceptable

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5/ CAES is a computerized order routing and execution facility which is made available to NASD members using the hardware of the NASDAQ automated quotation system. For a description of NASDAQ, see p. 8, infra.

6/ The ITS is an intermarket communications system operated jointly by certain national securities exchanges and the NASD and authorized by the Commission, on a provisional basis, as a national market system facility pursuant to Section 11A(a)(3)(B) of the Act. The current participants in ITS are the NASD and the NYSE, AMEX, Boston, Cincinnati, Midwest, Pacific and Philadelphia Stock Exchanges. The NASD became an ITS Participant as of May 17, 1982. See Securities Exchange Act Release No. 18713 (May 6, 1982), 47 FR 20413.

means of addressing those concerns. In this connection, several significant industry proposals emerged. Under the auspices of the Securities Industry Association ("SIA"), a special committee of OTC and exchange representatives, the "DeNunzio Committee," 7/ agreed upon certain principles that should be incorporated in a rule addressing "order exposure" 8/ if it was determined that such a rule was necessary. Those principles generally would require both exchange and OTC market makers to expose their customer orders to all other market centers or market makers before executing those orders as principal. In addition, the NYSE submitted a proposed rule to the Commission which resembled the SIA Committee's order exposure principles, but limited the rule's applicability to OTC market makers. 9/

7/ The Committee is named for its Chairman, Ralph DeNunzio, President of Kidder Peabody & Co., Inc. and former Chairman of the SIA, who volunteered to organize an industry-wide examination of issues related to internalization.

8/ "Order exposure" is basically the antithesis of internalization and contemplates the exposure of an order to other market centers, providing the opportunity for that order to be executed at a superior price.

9/ The NYSE now supports a rule applicable to OTC and exchange market makers. See letter to John S.R. Shad, Chairman, Securities and Exchange Commission, from William M. Batten, Chairman and Chief Executive Officer, NYSE, dated July 23, 1982.

In May 1982, the ITS/CAES linkage became operational on a pilot basis for 30 of the most actively traded 19c-3 Securities. Recognizing that industry initiatives toward formulating a consensus approach to order exposure had progressed as far as possible without Commission intervention, the Commission also commenced a rulemaking proceeding which proposed alternative Commission approaches to addressing order exposure.

Specifically, the Commission proposed three alternative approaches to addressing order exposure concerns. The first alternative would defer action on an order exposure measure until such time as action is warranted by demonstrable harm resulting from internalization. The second alternative, based substantially on the rule proposal submitted by the NYSE, and designated as proposed Rule 11A-1(A), would apply only to OTC market makers in Rule 19c-3 Securities, and would require such a market maker, prior to executing a customer's order as principal, to expose for 60 seconds both the customer's order at a price an 1/8th better than the intended execution price, and, if the intended execution price was superior to its principal quotation, the proposed execution price. 10/ After doing so,

10/ The market maker would be required to "stop" the customer order (*i.e.*, guarantee the execution at the intended execution price) for the 60 second exposure period.

if the customer did not receive an execution at the superior price, the market maker may execute its customer's order as principal at the stop price. The third alternative, designated Rule 11A-1[B], is an order exposure rule based substantially on principles developed by the SIA's special committee. That rule is referred to as the "All Market Rule" because it would apply similar order exposure requirements to both off-board and exchange market makers. The most significant difference between Rules 11A-1[A] and 11A-1[B] (other than the extent of applicability) is that the latter rule would not require market makers to display a principal quotation matching the proposed execution price. 11/

In the context of an order exposure rule, a number of issues and policy matters remain unresolved. As a threshold matter, the Commission first must determine whether, in light of the costs and benefits associated with an order exposure

11/ Both proposed Rules would provide an "export" alternative which would permit an OTC market maker to compete for its customer's order by maintaining a competitive quotation in CAES, and routing the order to CAES on a neutral basis. This alternative would require the market maker to put in place procedures which would preclude (i) persons at the market maker's firm responsible for proprietary trading from having knowledge of the customer order prior to its entry into CAES; and (ii) having persons responsible for dealing with customer orders from having any knowledge of the firm's proprietary positions or trading strategy.

rule, it is necessary to adopt such a rule for trading in Rule 19c-3 Securities. Second, if the Commission does determine to adopt such a rule, it will be is faced with the difficult task of facilitating the development of a rule which will provide effective exposure of all orders while minimizing inefficiencies and disincentives to market making created by the exposure requirement. In addition, the Commission must determine whether an order exposure rule should be applied to the small order automatic execution systems operated by the regional exchanges (if an "All Market Rule" is adopted), and whether there should be exemptions for small orders and block and agency cross transactions.

The Commission is presently considering these and other issues relating to order exposure while monitoring the impact of Rule 19c-3 in the linked trading environment.

B. Developments in the OTC Market -- National Market System ("NMS") Securities

In the last decade, the OTC market has grown from a loosely-defined market to a highly automated and efficient alternative to exchange trading. The impetus for these developments was introduction of the NASDAQ inter-dealer quotation service in 1971, which, for the first time, provided a vehicle for the real-time dissemination of OTC quotation information. In 1980, the information available with respect to OTC quotations again was improved when the representative bid and asked quotations made available in the newspapers and over NASDAQ Level I was replaced by the inside best bid and offer. This process of improving the information for NASDAQ securities continued with the Commission's "NMS securities" initiative pursuant to Section 11A of the Act, which, for the first time, has resulted in real-time transaction reporting for a limited number of actively traded NASDAQ securities.

Section 11A(a)(2) of the Act directs the Commission to designate, by rule, securities qualified for trading in the national market system. On February 17, 1981, the Commission adopted Rule 11Aa2-1 which establishes criteria and procedures by which certain NASDAQ securities will be designated as "NMS securities." 12/ The primary effect of designating a security as an NMS security is to require that last sale reports for the security be made generally available on a real-time basis. In this regard, the Commission determined that real-time transaction reporting for actively traded OTC securities would increase market efficiency and would enhance opportunities to ensure best execution of public investor's orders.

12/ Securities Exchange Act Release No. 17549 (February 17, 1981), 46 FR 13992.

As a functional matter, the rule employs a two-tiered approach to designating securities. Forty-one of the most actively traded OTC securities which satisfied the stringent "Tier 1 criteria" of the rule were designated beginning April 1, 1982. 13/ This list is updated on a quarterly basis, and, as a result, the number of Tier 1 companies has increased to 62. In addition, those securities meeting the "Tier 2 criteria" will be eligible for designation by mid-1983, if the issuers of such securities so elect. Currently, approximately 450 NASDAQ securities meet the Tier 2 criteria. 14/ Both the Tier 1 and Tier 2 criteria contain standards similar to exhange listing standards, including requirements concerning assets of the issuer, number of outstanding shares and trading volume.

During the Commission's proceedings leading to the adoption of Rule 11Aa2-1, and since the adoption of the rule and the beginning of the designation process, representatives of

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13/ Although the initial Tier 1 designation became effective in April, dissemination of last sale information through NASDAQ Level I and the wire services began on June 1, 1982. All quotation vendors were not carrying this information until late July, 1982.

14/ This number may fluctuate substantially based on volume trends. Therefore, recent high volume periods may result in substantially more OTC securities meeting the Tier 2 criteria.

the OTC trading community argued that designation, and the resulting transaction reporting, would result in disincentives to OTC market making (i) due to the direct (e.g., clerical) costs of such reporting, (ii) because there may be potential customer confusion resulting from the fact that, because there is no rule prohibiting "trade-throughs" in the OTC market, transactions may be reported at prices inferior to a customer's limit price without the customer receiving an execution, and (iii) because OTC market makers might be less willing to acquire a position in a security subject to transaction reporting due to the concern that they would be unable to liquidate effectively a significant position if their competitors were aware, via transaction reporting, of the size of that position. Due to those concerns, a number of prophylactic measures have been instituted.

First, the Commission, in establishing the Tier 1 and Tier 2 criteria, struck a conservative balance and attempted to ensure that only the most liquid OTC securities would be eligible for designation. With respect to those securities, the Commission determined that the benefits of transaction reporting, including increased market efficiency and enhanced opportunities for best execution, outweighed any market liquidity concerns rasied by the commentators. Second, the Commission's determination with respect to Tier 2 securities was based, in part, on the fact that issuers would be able to make individual determinations regarding the desirability of designating their securities. Third, the Commission permitted OTC market makers, under certain conditions, to "bunch" orders for reporting purposes in order to reduce the administrative burdens of reporting during high volume periods. Finally, the NASD, with input from the Commission and the industry, is developing a plan to "phase in" the Tier 2 securities over a period of time in order ease the potential burden of having to report transactions in up to 450 additional securities at one time. 15/

The first results of the monitoring of trading in Tier 1 trading are just beginning to be analyzed. Preliminary data indicates that there has not been a diminution in Tier 1 market making interest. In addition, there do not appear to have been any adverse effects on liquidity for this initial group of securities. The long-term effects of transaction reporting, however, have yet to be determined.

C. Options

Multiple Trading of Options

In its 1980 release announcing the termination of the options moratorium, 16/ the Commission identified a number

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15/ The NASD also is developing technical enhancements to allow reporting of transactions through an interface of a firm's internal computer system and NASDAQ.

16/ Securities Exchange Act Release No. 16701 at 26-27 (March 28, 1980), 45 FR 21426.

of potential benefits to public investors and market professionals that could result from multiple trading in equity options, including intermarket competition resulting in more efficient pricing, execution and clearing services. Nonetheless, in light of fragmentation and fair competition concerns, as well as questions about the effect of multiple trading on the viability of certain regional exchanges, the Commission determined to defer action on this issue.

In December, 1981, however, the Commission issued a policy statement indicating that it did not believe its decision to defer consideration of whether to permit multiple trading in equity options should apply to nonequity options. 17/ The Commission indicated that certain of the competitive factors considered previously, such as the impact of multiple trading on the regional exchanges, were not present with respect to non-equity options. In addition, the Commission noted that it did not wish to assume a franchising role in what appeared to be a limited number of non-equity products. 18/ The Commission also noted in the release that its concerns with respect

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17/ Securities Exchange Act Release No. 18297 (December 2, 1981), 46 FR 60376.

18/ Shortly thereafter, the Commission approved rule changes by both the Chicago Board Options Exchange ("CBOE") and the AMEX to allow the trading of options on Treasury securities. See Securities Exchange Act Release No. 18371 (December 23, 1981), 46 FR 63423. In addition, the Commission indicated its intention to approve the NYSE's proposal to trade Treasury options upon receipt of final amendments to the filing.

to market dominance that had precluded the NYSE from participating as a competitor in equity options were not present with respect to debt options, and, accordingly, it did not believe it appropriate to exclude the NYSE from this market.

There currently are pending before the Commission proposed rule changes by the AMEX, CBOE and NYSE and the Pacific Stock Exchange to trade options on stock groups and proposals by the NYSE, AMEX, CBOE, and NASD to trade options on stock indices. In the course of considering these proposals, it may be necessary for the Commission to determine whether multiple trading should be permitted, as in the non-equity options context, or whether the current ban on expansion of multiple trading of equity securities should extend to options or groups or indices comprised of equity securities.

The potential entry of the NYSE into the options market raises several concerns that were discussed in the Special Study of the Options Market 19/ including (1) the trading by the NYSE of options on underlying securities for which it is the dominant market and (2) the integration of the trading of options and the underlying securities in the same physical

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19/ *See* Report of the Special Study of the Options Markets to the Securities and Exchange Commission, 96th Cong., 1st Sess. p. 983-1028 (Comm. Print 1978) ("Options Study").

location or by the same market participants. A number of commenters have raised these issues in connection with the Commission staff's review of the NYSE's filings, and the staff is actively reviewing this area. Although these concerns do not appear as compelling with respect to new products other than options on individual equity securities, there are nevertheless a number of significant issues related to NYSE entry into the option market generally. In particular, the CBOE, AMEX and Philadelphia Stock Exchange have argued that small industry stock groups may be substantially fungible with individual stock options, thus raising substantially different concerns than the trading of debt options by the NYSE.

II. Potential Developments in the Market

A. Individual versus Institutional Trading

One of the most important structural changes facing the nation's securities market is the possible emergence of a two-tiered securities market with separate treatment of institutional and individual investors. Trends over the past several years indicate the possible beginning of such a bifurcated marketplace; at the current time, however, it is unclear where this trend is leading.

In the early 1970's, although there was pressure being applied to the system, the manner of executing small individual orders and large institutional orders, as well as the commissions charged for such executions, were fairly similar. Two significant market developments have changed that. First, the complete unfixing of commission rates in 1975 rapidly produced a new economic structure for recovering execution costs. As shown in the Commission's recent study on commission rates prepared by the Directorate of Economic and Policy Analysis, 20/ the unfixing of commission rates has resulted in institutions paying significantly less commissions than individuals, both on a percentage of principle value basis and on a cents per share basis.

A second significant development separating the individual and institutional investor, partly as a result of the competition fostered by the unfixing of commission rates, concerns the manner of order execution. Specifically, while large orders in listed securities continue to be sent to the floor broker for individual attention, the industry has been attempting to find a more efficient vehicle for executing the small individual order. 21/ The two primary exchanges, the NYSE and AMEX have

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20/ Securities and Exchange Commission, Commission Rate Trends, 1975-1981, July 7, 1982.

21/ The distinction between individual and institutional investors may more accurately be described as a distinction between large and small orders. Of course, this similarity does not hold true in all cases since individuals sometimes execute large orders, and institutions small orders.

developed order routing systems to allow firms to send small orders directly to the specialist, thus bypassing the floor brokerage system. These systems are known as the Designated Order Turnaround ("DOT") and Post Execution Report ("PER") systems, respectively. Also, the Pacific, Philadelphia and Midwest exchanges have developed systems that provide automatic execution of small orders based on the best price currently available in an ITS market center. These systems are known as SCOREX, PACE and MAX, respectively. In addition, CAES, operated by the NASD, and the Cincinnati Stock Exchange's National Securities Trading System are automatic execution systems which, although available for all orders, generally are used for individual-sized orders.

The development of small order processing systems appears to be far from over. Merrill Lynch long has proposed increasing the size of the odd-lot, which would allow a broker-dealer to execute small orders in-house. The NYSE is developing a program called the Registered Representative Rapid Response System which would allow rapid quote-based executions at the registered representative level. It would appear that in an era of competitive commission rates and escalating volume there will continue to be significant pressures to automate small order processing further, a step which only can lead to the further separation of the individual and institutional markets. On the one hand, these developments would appear to be desirable for individual investors because they permit firms to execute small orders in a more efficient and less costly manner. On the other hand, automatic quote-based executions do not provide an opportunity for customer orders to receive a superior execution through exposure to other trading interest. Of perhaps greater significance is the effect on the pricing mechanism if all small orders were executed automatically on a derivative basis. Arguably, while orders on a aggregated basis would still participate in the auction market, it is unclear whether market makers might change their pricing policies if they saw no small order flow.

B. <u>Public Limit Order Protection</u>

Since the national market system first was proposed, a continuing concern has been the protection of public limit orders in listed securities. This concern has been based on a general perception that bypassing public limit orders by executing a block transaction away from the primary market disadvantaged public customers. At the same time, there was a competitive aspect to this concern because, as a practical matter, non-primary market centers had to provide their limit orders, as well as other orders, with protection against superior executions in the primary market. A solution to this problem, however, has been difficult to fashion without disrupting the efficiency of block trading procedures.

Both in 1978 and 1979 the Commission called for the industry to implement a system to provide for intermarket protection of public limit orders. 22/ The Commission followed those releases with a proposed rule that would have provided protection for all displayed public limit orders against executions at inferior prices. 23/ These Commission initiatives were followed by an industry proposal to develop a Limit Order Information System ("LOIS") that would have provided protection to limit orders entered into LOIS and disseminated to all market centers. Further industry discussions, however, indicated that LOIS would have been manually intensive and extremely expensive, especially in light of the limited protection it would provide. 24/ Thus, the concept of LOIS was abandoned while the parties continued to explore alternative means of providing protection for public limit orders.

Current industry discussions center on using the ITS to provide notice of block trades and giving market centers time

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22/ Securities Exchange Act Release Nos. 14416 (January 26, 1978), 43 FR 4354; and 15671 (March 22, 1979), 44 FR 20360.

23/ Securities Exchange Act Release No. 15770 (April 26, 1979), 44 FR 26692.

24/ Current exchange and NASD rules provide price protection to displayed quotations, at the quote price for most trades and at the execution price for block-sized trades at inferior prices. Only away-from-the-market limit orders not included in a market center's display of a best and offer now are in need of protection.

to respond with interest at specific prices. In addition, in the order exposure area, the DeNunzio Committee has indicated that it is exploring possible ways in which blocks might be exposed to other interest on an inter-market basis. Problems with the current proposals include the length of time to respond to such inquiries and the extent, if any, of dealer participation. The ITS participants are continuing their discussions in an attempt to resolve these remaining problems.

C. <u>International Markets</u>

Over the last few years we have seen a trend toward increased internationalization of the capital markets continue to accelerate. The NYSE has begun admitting domestic subsidiaries of foreign broker-dealers and has been actively soliciting the listing of world class securities. In addition, foreign securities markets, such as the Eurodollar market, have undergone significant growth and are becoming, in some respects, realistic alternatives to the domestic markets in which United States issuers can raise capital. Also, the availability of foreign investments in the United States, including foreign securities, American Depositary Receipts on such securities and investments such as Trans-Canada Options continue to grow. While it is premature to arrive at any definitive conclusions concerning these developments, they ultimately could call into question the preeminence of U.S.

markets worldwide and the preeminence of securities of United Stated issuers domestically.

In this regard, the trend toward internationalization has raised a number of specific problems that the Commission must address. First, the practice of foreign issuers raising capital in the United States presents problems with respect to the Commission's and investor's ability to institute civil actions, and to serve subpoenas, with respect to securities law violations. Accordingly, in its release on integrated disclosure for foreign private issuers, 25/ the Commission specifically requested comment on the possibility of requiring foreign private issuers filing registration statements with the Commission to designate an agent for service of process in the United States.

A second issue concerns the ability of foreign issuers to register their securities for trading on NASDAQ. As previously discussed, 26/ NASDAQ is an automated OTC interdealer quotation device that has been a significant factor in the upgrading of the OTC market. To ensure that adequate public information is available for securities quoted through NASDAQ, the NASD generally limits NASDAQ to securities registered under Section 12 of the Act. The NASD, however, allows those foreign securities exempt

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25/ Release Nos. 33-6360, 34-18274, 39-677, November 20, 1981, 46 FR 58511.

26/ See page 8, supra.

from such registration pursuant to Rule 12g3-2(b) 27/ to be registered on NASDAQ. This exemption raises concerns both with respect to the information available covering such foreign securities and with respect to the Commission's ability to halt trading in such securities beyond an initial 10 day period. 28/ Both the NASD and the Commission are considering steps to remedy these concerns.

III. New Financial Products and Capital Formation

Since the advent of exchange-traded options in 1973, and the trading of futures on debt instruments in 1975, a principal area of focus has been the effect of these instruments on the capital formation process. Conceptually, options and futures have the potential both to facilitate capital formation and to divert investor interest from other types of investments.

Options on individual equity securities allow investors to hedge stock positions, and to generate premium income through covered writing. The availability of these strategies may encourage investment activity in the underlying securities. In

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27/ Rule 12g3-2(b) exempts from Section 12 registration those foreign securities where certain information that is filed, distributed or made public in the issuer's domicile also is filed with the Commission.

28/ Section 12(k) of the Act allows the Commission to halt trading for 10 days. Further trading halts usually must be accomplished by invoking Section 12(j) to suspend Section 12 registration.

addition, the availability of options to speculative market participants may result in deeper and more liquid secondary markets for the underlying securities, which may also encourage investment. On the other hand, as a leveraged speculative vehicle, it has been suggested that options may serve to undermine the capital formation process by diverting capital from other venture capital investments.

It has been maintained that futures on debt securities can be used by government securities dealers and corporate bond underwriters to hedge positions in those debt securities, thereby permitting those dealers and underwriters to take down larger positions. There is some evidence that the futures markets have been used successfully for precisely this purpose. On the other hand, concern has been expressed that futures trading could destabilize the underlying debt markets. While there is some evidence that suggests that futures trading may, under certain circumstances, hold the potential to influence the market in the underlying debt instrument, 29/ it generally is felt that futures trading

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29/ For example, the Commodities Futures Trading Commission ("CFTC") has compiled evidence suggesting that activity in the 90 day Treasury bill market may have been influenced in the past by abnormal delivery of Treasury bill futures contracts. See, Report to Congress in Response to Section 21 of the Commodity Exchange Act regarding developments in the Silver Market ("Silver Study"), Part III, p. 6 (May 29, 1981). Those deliveries apparently were motivated largely by incentives in the tax laws which were eliminated by the Tax Staddle Act of 1981.

has little discernable effect in the debt markets, and even may contribute to depth and liquidity in those markets.

Although not specifically required under the federal securities laws, the Commission in the past has found that the proposed new options products considered to date (Government National Mortgage Association ("GNMA") and Treasury options) have the potential to serve a variety of economic uses, 30/ including facilitating hedging against adverse interest rate movements by mortgage bankers, portfolio managers, financial institutions and commercial borrowers. Futures and options on stock indices and other stock aggregates also can be employed as hedging vehicles. For example, institutions or mutual funds which hold portfolios which are generally equivalent to a particular index may employ index options or futures to hedge against an adverse move in the portfolios.

The Commission's Options Study reviewed a number of empirical studies conducted in the early years of stock options trading on the effects of that trading on the capital formation process. 31/ These studies showed either that there was little discernible effect or they were inconclusive. Similar studies have not been

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30/ See Securities Exchange Act Release No. 17577 (February 26, 1981) ("GNMA Release"), 46 FR 15242, and Securities Exchange Act Release No. 18371 (December 23, 1981) ("Treasury Release"), 46 FR 63423.

31/ See Options Study, supra note 19, at 12-18.

conducted more recently and, to our knowledge, have not been conducted with respect to the futures markets. This will be a principal focus of a study to be headed by the Federal Reserve Board, with participation from the CFTC and the Commission, in the proposed legislation to enact the SEC/CFTC accord. 32/

The possible effects of new financial products on capital formation also raise broader questions concerning the role of the Commission generally in the capital formation process. For example, although tax policy and other economic policies have changed to respond to the new issues with respect to the increased need for capital formation, the consistent focus of the Commission's work has been on the protection of investors. Accordingly, some have suggested that the securities laws should be amended to charge the Commission with the duty to facilitate capital formation, while others have suggested that the existing "public interest" standard now contained in the Securities Acts is sufficient for the Commission to take into account any effect on capital formation resulting from its actions. The issue

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32/ See H.R. 5447 as amended by the House Committee on Energy and Commence, which would add a new Section 23 to the Commodity Exchange Act directing the Federal Reserve Board to head a study of the impact of Financial Futures on, among other things, the capital markets. H.R. Report 565, Part II 97th Cong., 2nd Sess 2. (1982). (Subsequent amendments to H.R. 5447 may include options in the study.)

facing the Commission and the public is to determine whether this change would affect the Commission's other statutory goals. In particular, if such a change were adopted, would it, therefore, be appropriate for the Commission to modify its pursuit of the the protection of investors and the maintenance of fair and orderly markets?

In this regard, Chairman Shad, in connection with the Commission's testimony concerning the Glass-Steagall Act, has called for the formation of a non-partisan task force to examine Glass-Steagall issues, including the effect of current federal banking and securities laws on the ability of issuers to raise capital. Similarly, Representative Timothy Wirth, of the House of Representatives Committee on Energy and Commerce, has introduced legislation to establish a commission on capital markets to evaluate federal and state regulation of financial institutions. Thus, the long-term issue would appear to be: how can regulation of diverse financial intermediaries be designed in such a manner as to encourage additional capital formation, while at the same time providing for the protection of investors and the maintenance of fair and orderly markets?

IV. Conclusion

Significant progress has been made toward a National Market System over the last few years. Nevertheless, significant issues in that area currently are being addressed or will be addressed in the forseeable future. In addition, recent developments indicate that the industry and the Commission will continue to have to address broader questions, including the issue of internationlization of the securities markets and capital formation.