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MEMORANDUM

TO: Chairman Ruder

FROM: Richard G. Ketchum, Director
Division of Market Regulation RK

DATE: September 17, 1987

RE: Meeting with John L. Watson, III, President of the National Security Traders Association, on Monday, September 21, 1987

I. Background

The National Security Traders Association ("NSTA") is an international association of nearly 7,000 securities industry professionals. Originally chartered in 1934 to advance the interests of over-the-counter ("OTC") market professionals, it gradually has broadened it membership and objectives to include traders, partners and shareholders of national firms and registered representatives involved in all segments of the industry. NSTA has 33 affiliated organizations in the United States, Canada and Western Europe. 1/

The NSTA is governed by an eight-member Board of Governors, a chairman elected by the affiliated organizations, and a full-time president. 2/ NSTA also has established a network of committees to carry out the Association's objectives, including the Exchange Liaison Committee, the Institutional Committee, the International Advisory Committee, the NASD Liaison Committee and the Trading Issues Committee. The NSTA has taken an active role in numerous industry issues. The Association was a strong supporter of the creation of the NASDAQ system and of making OTC securities eligible for margin trading. 3/

1/ As of last April, NSTA included among its affiliates the Montreal Equity Traders Association, the Vancouver and Toronto Equity Traders Association and the International Equity Dealers Association, representing most of Western Europe. The group intends to expand next to Hong Kong, Tokyo and Singapore.

2/ NSTA's current Chairman is Arthur P. Rowsell, of Instinet Corporation; the current President is John L. Watson, III.

3/ Currently, the over 3,000 OTC securities which have been designated as National Market System securities are automatically eligible for margin trading. Other OTC securities may separately qualify.

II. Third-Market Options Trading

The NSTA also has submitted comments on numerous Commission and self-regulatory organization initiatives. Most recently, the NSTA submitted comments on a recent NASD proposed rule change implementing a one-year pilot program to permit NASD members to internalize customer orders (i.e, execute orders in-house without exposure to the trading floor) in options on OTC securities that currently trade only on an exchange. Under the proposal, the NASD will require its members to report such trades in a timely manner through the Internalized Trade Transaction ("ITT") message function in the NASDAQ system. Further, NASD members would be obligated under NASD rules to effect these customer transactions at the best market price. The NSTA strongly supported the proposal in its comments to the Commission. NSTA stated that it believes there is a legitimate need among NASD members to provide these services to their customers and that the NASD has incorporated appropriate safeguards to ensure that customers' orders are adequately protected. The NSTA cautioned, however, against a Commission requirement that such orders be exposed to the exchange floors on which the options are traded because such a requirement would be overly burdensome and because there is no similar requirement on all exchanges that trade multiply traded options. We expect, however, that the options exchanges will oppose vigorously this proposal as being inconsistent with maintaining a central auction market for options trading and failing to ensure that customer limit orders will be protected (i.e., orders executed in-house by a broker-dealer firm would not have to clear the options exchange limit order book).

III. Small Order Execution System

The NSTA also commented on a recent NASD proposal to prohibit NASD members from using the NASD's Small Order Execution System ("SOES"), the NASD's automated, order execution system for small agency orders, if they are registered as NASDAQ market makers for a NASDAQ security but are not also registered as SOES market makers. Although the NSTA found no fault with the proposal, it cautioned the NASD against adopting too many rules that might hamper the use of SOES. The NSTA, noting competition from proprietary execution systems (i.e., small order execution systems operated by broker-dealer firms and made available to other correspondent firms), encouraged the NASD to maximize use of SOES and to consider loosening restrictions on the system if necessary to encourage broader use.

IV. National Market System

Although somewhat less current, we believe a comment letter submitted by the NSTA in response to a Commission release on Rule 11Aa2-1 ("NMS Securities Rule") is a good illustration of the

Association's position an numerous National Market System ("NMS") issues. The release requested comments on whether the Rule should be amended to include other types of securities, primarily exchange-listed, within the definition of the term "NMS securities." The focus of the letter was the NSTA's position on the appropriate framework for the NMS. First, the NSTA supported the inclusion of reported, exchange-listed securities as NMS securities. (The Commission adopted this approach last June.) It cautioned, however, that in addition to transaction reporting, NMS Securities should exhibit certain other characteristics, including substantial capitalization and substantial assets and earnings histories. It also urged the Commission to respect the integrity of both auction (i.e., exchange) and negotiated (i.e., OTC) markets and urged the Commission not to impose rules appropriate for exchange markets on the OTC market. For example, the NSTA believes that there is no demonstrated need for a trade-through rule (i.e., prohibiting one market from executing an order at a price inferior to another market's displayed quotation) or a prohibition of short sales in the OTC market.

The NSTA believes that there are several obstacles that the Commission must remove before a "true" NMS will be achieved. Primarily the NSTA is concerned about OTC market makers access to exchange markets. Among the barriers they cite are the practice of some firms to route automatically orders to an exchange; unequal execution facilities (i.e., no provision for the automatic execution of orders routed to exchange floors), a lack of a neutral order switch (i.e., a facility to ensure that orders are routed to the best displayed market rather than automatically being sent to a predetermined market), specialists who continually trade-through OTC markets; and restrictive trading rules, such as off-board trading restrictions and onerous exchange delisting requirements.

V. Trading Halts

There are several other issues in the OTC market that the NSTA may have on its agenda. For example, last spring the NASD submitted a proposed rule change to the Commission, which, if approved, would clarify the NASD's authority to call regulatory trading halts in NASDAQ securities and in listed securities traded in the third market when the primary exchange market for those securities calls a regulatory trading halt. 4/ The staff currently is reviewing the proposal and the comments submitted. Jefferies and Company, Inc. ("Jefferies") strongly opposes the NASD's proposal and submitted comments questioning the NASD's statutory authority to adopt the rule. Jefferies also asserted that granting the NASD the authority to impose trading halts in

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4/ A "regulatory trading halt" generally is a halt called because of a pending material news dissemination.

the OTC market would be a poor policy decision because it would encourage investors to trade in foreign markets, beyond the regulatory scrutiny of United States regulatory agencies.

VI. Affiliate Market-Making

Also last spring, the NASD examined the conflicts of interest that could arise when a broker-dealer firm trades securities issued by its parent company or affiliate and requested comment from its members on a proposal to prohibit firms from making markets in securities issued by their affiliates. The NASD received many negative comments, particularly from the mortgage-backed securities industry, which convinced the NASD that a rule was not needed. Although the NASD rejected the general rule, it still is studying a rule regarding market making by affiliates in common stock.

VII. NASD-LSE

Another issue the Commission has confronted recently involves a quotation linkage between the National Association of Securities Dealers, Inc. ("NASD") and the International Stock Exchange of the United Kingdom and the Republic of Ireland, Ltd. The Commission initially approved the linkage for a six-month pilot period, and has granted five interim approvals in order to address the concerns of the Institutional Networks Corporation ("Instinet") expressed in two adverse comment letters on the proposal. Instinet has expressed concerns that the quotation sharing agreement between the NASD and the Exchange is violative of Sections 11A and 15A of the Act and general antitrust principles, and generally discriminates against Instinet in its role as a vendor of quotation information. The Division is working to address Instinet's concerns and will submit its recommendation to the Commission in the near future.

VIII. Blue Sky

The issue of "Blue Sky" registration exemptions for NASDAQ/NMS securities has been one of the focal points of the competition between the American and New York Stock Exchanges, and the NASD for new listings. Historically, many states have provided registration exemptions for exchange-listed securities, while requiring OTC securities to be registered. A number of states, however, adopted so-called "blue chip" exemptions that tied registration exemptions to certain characteristics of the security and its issuer, rather than the locus of trading. Since January of 1985, a number of states have adopted "blue sky" exemptions for NASDAQ/NMS securities. The Division believes that disparate "blue sky" treatment of NASDAQ/NMS and exchange-listed securities is no longer warranted. It is preparing a letter for the Commission's consideration to the President of the North American Securities Administrators Association endorsing the development of "blue sky" exemption standards for NASDAQ/NMS securities that are comparable to exemptive standards for exchange-listed securities.

IX. Proposed Rule 10b-21

In response to a petition for rulemaking filed by the National Association of Securities Dealers, Inc. ("NASD"), the Commission published for public comment Rule 10b-21 ("Rule 10b-21" or "Rule") under the Securities Exchange Act of 1934 ("Exchange Act") [Release No. 34-24485 (May 20, 1987)]. The release addresses the practice of manipulative short selling prior to a public offering, which results in a decrease of the price of the security prior to the offering date and a lower offering price, thereby depriving the issuer of offering proceeds that would have been realized had the market not been subject to short selling. Proposed Rule 10b-21 would prohibit a person who effects short sales of an equity security during the period between the filing of a registration statement relating to the same class of equity securities and the commencement of the distribution of such equity securities, from covering such short sales with securities purchased from an underwriter or other broker or dealer participating in the offering of such securities. The staff will prepare an analysis of the 17 comment letters it has received as a result of the Commission's request for comment on the proposed Rule.

X. Limit Orders

Finally, we note for your information only, that there is currently pending before the Commission an appeal styled E.F. Hutton v. NASD (the so-called "Manning" case) which involves the responsibilities of a broker-dealer in handling a customer's OTC limit order. In due course, the Office of Opinions and Review will be submitting appropriate briefing memoranda regarding this case. We alert you to it now only because you should be aware of the issue's litigation sensitivity.

cc: Linda Fienberg