

Congress of the United States

house of Representatives
Committee on Interstate and Foreign Commerce
Room 2125, Rayburn house Office Building
Washington, D.C. 20515

October 19, 1979

Honorable Harold M. Williams
Chairman
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Dear Mr. Chairman:

We appreciate the participation by you and your fellow Commissioners in the hearings held by the Subcommittees on Oversight and Investigations and Consumer Protection and Finance regarding the progress towards the development of a national market system. The hearings were useful to the Subcommittees in understanding recent developments related to the implementation of the Securities Acts Amendments of 1975.

As a supplement to the record, we would appreciate your comments regarding the following matters. To facilitate printing of the record, please provide the Subcommittees with your answers by November 9, 1979.

A. In March of this year, the Commission modified the position it had taken the previous year with respect to time priority in a national market system:

“absolute time priority proposed to be afforded public limit orders entered in the Central File would have significant deleterious effects on the exchange trading process. Therefore, the Commission decided to allow the participants to develop some sort of limit order protection through the Intermarket Trading System.”
 (“Status Report on the National Market System,” 44 Fed. Reg. 20360, (1979), hereinafter, “March release”)

What specifically are the “significant deleterious effects” on the trading system which the introduction of time priority would have? On what analysis is this conclusion based? What plans does the Commission have for study and consideration of this issue in the future? If an inter-market price protection system is developed, as is currently contemplated by the Commission, and later the Commission returns to its earlier position with respect to time priority, how easy will the transition to time/price protection be? [That is, will systems currently being developed to meet the price protection requirements be readily adaptable to time/price priority or will entirely new systems and devices have to be developed?]

In the March release, the Commission stated that a price protection system should be implemented, on a pilot basis, by the end of December, 1980. Why is one year and nine months required to put such a pilot program into operation?

In footnote 31 of the March release the Commission suggested that a rule may not be necessary to assure intermarket price protection. Following the suggestion of the New York Stock Exchange, you observed that “voluntary procedures” may be adequate to assure price protection. In light of testimony by witnesses appearing before the Subcommittees that specialists and brokers sometimes are not now using the ITS system to send an order where the better price is, how does the Commission expect such a “voluntary procedure” to provide adequate price protection?

B. At the hearings, Chairman Williams stated that with respect to removal of the New York Stock Exchange’s Rule 390, the Commission has indicated to the industry that “so long as meaningful progress was being made towards implementation of a national market system,” the Commission would consider deferring removal of the rule. What is “meaningful progress?” What is the criteria used to determine whether or not “progress” is being made? What is the criteria for determining the point at which progress is no longer being made? In view of the lack of certainty as to the ultimate configuration of a national market, how can the Commission judge whether particular developments constitute “progress” towards the development of a national market system?

1. In administrative hearings regarding the off board trading restrictions, witnesses have raised a variety of reasons for opposing removal of the restrictions [for example, “internalization,” lack of equal regulation]. What specifically is the agency doing to try to determine which of these issues are problem areas, and to develop techniques for solving the problems?

2. There has been considerable concern expressed by the exchanges and by the Commission about the problem of “internalization,” or the misuse of public orders by the broker acting also as dealer. Does the Commission consider internalization or the prospect of internalization a significant problem? If it does, and if the Commission does not mandate time priority in the national market system, please describe with some detail a possible market system structure which avoids “internalization.”

How does the potential misuse of public orders by the broker acting as dealer differ from the specialist acting as market maker, plus acting as agent for orders left on the book, plus (in the case of the New York Stock Exchange) acting as agent for Designated Order Turnaround System orders?

Is the Commission satisfied that present surveillance systems are sufficient to preclude abuse in this area?

C. At the hearing, it was reported that inquiry has been made of the self regulatory organization regarding their enforcement of the quotation information rule. What have been the results of this inquiry? What is the most egregious problem with respect to compliance with the rule which has arisen? What enforcement actions has the Commission brought for violations of the rule?

In the March release the Commission stated it expected exchanges to take "prompt action" to correct quotation problems. What action did the exchanges take? When did they take it? Is the Commission satisfied with the response of the exchanges to that admonition? If not, what will the Commission do?

In the March release, there is a footnote urging vendors to comment on the costs of achieving the goal of "displaying transaction and quotation information" a short time after receipt of the information. Have you received such comments? Generally, what have been the results of the inquiry?

D. In the March release, the Commission stated that it believed "the CSE System offers a unique opportunity for the study of certain issues," and that if exchanges and broker-dealers are not currently participating in the system, they should consider doing so. The Commission also suggested non-participants should consider letting the Commission know of their reasons for not participating in the system. How many responses have you received to these inquiries? What reasons have been given for non-participation in the system? Has the Commission done anything else to find out why there is not more participation in the system? If so, what are the results? What has the Commission done to find out why "[a]lthough CSE System terminals are installed on the floors of the BSE, MSE and PSE, specialists have made little or no use of the System"?

E. In the March release, the Commission observed that "the self-regulatory organizations and the securities industry have increased their collective commitment to enhance and perfect market linkage and information systems." Today, systems continue to operate rather independently of each other. What has the Commission done to "facilitate" the linking of these various systems? In the Commission's view, how important is a linkage between the third market, the ITS, and the Cincinnati facilities? If it is important, what incentive is there for the parties to accommodate each other?

In the case of a stalemate in discussions between the parties, what will the Commission do?

How do you anticipate that the Cincinnati system should interact with the ITS system? Specifically state how the mechanics of the inter-connections would operate and describe hypothetical transactions which would be made through the system.

F. In the March release, the Commission adopted the New York Stock Exchange's proposal that the existing NYSE/AMEX switch be adapted so that it will have the capacity to perform "message routing." The New York Stock Exchange indicated that it felt the project could be completed in three to six months following agreement on specific terms. The Commission indicated its acceptance of the New York approach. Further, the Commission acknowledged the existence of talks between the Midwest and the NYSE/AMEX regarding the availability of the switch. It urged those discussion be continued and that "a satisfactory agreement...be promptly reached." What is the status of the adaptation of the switch? What is the status of the discussions between the New York and the Midwest Stock Exchanges? What action has the agency taken in the last six months with respect to these matters?

Also in that release, the Commission deferred its decision with respect to imposing any requirements for order by order routing of retail orders to the best market. When and under what circumstances will this issue be considered?

G. In September, 1978, the D.C. Circuit Court remanded for reconsideration by the Commission two issues in Bradford National Clearing Corporation v. SEC, 590 F.2d 1085 (D.C. Cir. 1978). Six months later, the Commission solicited comments on the issues which were remanded.

What has the agency done to examine these issues? When will a decision be made regarding these issues?

H. The General Accounting Office criticized the Commission for the small number of and the nature of the qualifications of staff assigned to national market issues. On the other hand, the Commission has indicated there are more staff working on the issue than the GAO is willing to acknowledge. How many staff are assigned to national market issues? What proportion of their time is spent on these issues? How many of these positions are currently vacant?

The GAO raised questions about the length of time required to develop the composite quote system and the transactional tape. Much of the Commission's testimony was devoted to listing the issues which had to be addressed in conjunction with implementation of a consolidated quotation system. Can you be more specific as to why several years were required to resolve the questions related to the implementation of a consolidated quotation system? Was it a problem of obtaining adequate information on which to base decisions or of accommodating diverse views on certain matters? What other factors are involved?

Did the Commission evaluate the data processing capability of the Securities Industry Automation Corporation? If so, could you furnish the Subcommittees with a report on that evaluation?

I. In his testimony, Mr. William Schreyer of Merrill Lynch, Pierce, Fenner and Smith, Inc., raised a question about the ability of the current system to cope with high volume trading days on a sustained basis. What is your assessment of the ability of industry to handle a sustained level of high volume?

Also in his testimony, Mr. Schreyer announced the development by Merrill Lynch of a system designed to route orders to the market showing the best quote for a stock. What is your assessment of the competitive implications for the securities industry of such a development? What does this mean for the Commission's role in facilitating the development of facilities designed to insure a fair field of competition?

J. Some witnesses in their written testimony raised concerns about the promptness with which the Commission handles the rule changes of the self regulatory organizations proposed under the requirements of Section 19(b) of the Securities Exchange Act of 1934. Please comment regarding the agency's problems in meeting the statutory deadlines. What is being done to resolve those problems? How many proposed rules subject to the Section 19(b) requirements are pending before the Commission? What is the average actual time that has elapsed for each of the steps in the process of consideration of the rule [i.e., from the date of receipt of the proposed rule to publication of notice of the filing; from publication to approval of the rule change, etc.]?

The Commission was also criticized for its failure to grant any unlisted trading privileges since December, 1977. How many such requests are pending? Why has the Commission not acted on these requests? Has it devised standards for the granting of such requests? If not, when will it do so?

Several witnesses raised the question of the manner in which options will fit into a new national market system environment. Please describe specifically what the Commission is doing to consider the question of options trading in the national market system.

Other witnesses raised concerns about the display requirements for quotations on the composite quotation system (CQS). Under the Commission's proposed rule, the CQS will show only the highest bid and lowest offer, not a montage of all bids and offers. How difficult would it be for the vendors to display all quotes, and what are the objections to doing so?

K. In what manner has the Commission considered the matter of the role of the market maker in today's system – i.e., the specialist as a market maker and the "upstairs" market maker – and what the role of the market maker should be in a new national market system? Has the Commission considered the question of the nature of affirmative and negative duties which should be imposed on market makers in a new system? If so, how has this been done? If not, what plans does the Commission have to consider this question?

L. In both the Commission's recent orders approving continued operation of the Intermarket Trading System (ITS) and the Multiple Dealer Trading System (CSE), there are footnote comments to the effect that the Commission will continue to consider the policy issues related to the ability of firms to transact business on a principal basis with their own retail customers and

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the need to ensure that order flow in every particular market center is exposed to buying and selling interests represented in other market centers. These deliberations, which “may well lead to regulatory initiatives which have a significant impact” on the CSE and ITS System, are matters which you said should be addressed in “a broad and generic context.” What plans does the Commission have for addressing these issues? What is the staff doing to study issues which would bear on the Commission’s final decision? What regulatory initiatives are contemplated?

M. Should the national market system accommodate odd lots trading within its environment or does odd lot trading have to be handled in a fully dealerized system as at present?

N. In the March status report, the Commission focused attention on the ITS, and stated that certain operation characteristics of the system must be “substantially improved.” One of these enhancements was “reduction in the length of time required to enter commitments to trade and receive execution or rejection reports.” In the six months that have elapsed since the March release, how much has the time required to use the ITS actually been reduced?

Thank you for your cooperation. If you have any questions please feel free to contact us, or the Committee staff: Kathryn Seddon, Counsel to the Subcommittee on Oversight and Investigations at (202) 225-5365 or Franz Opper, Counsel to the Subcommittee on Consumer Protection and Finance at (202) 225-7790.

Sincerely,

James Scheuer
Chairman
Subcommittee on Consumer
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Bob Eckhardt
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cc: Commissioners:
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