


**NY STOCK
EXCHANGE**

John J. Phelan, Jr.
President and
Chief Operating Officer

January 20, 1981

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

CHAIRMAN'S OFFICE

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SEC. & EXCH. COMM.

Dear Harold:

The request of the National Association of Securities Dealers (NASD) for an electronic linkage between its Computer Assisted Execution System (CAES) and the Intermarket Trading System (ITS) has been a matter that has been studied carefully by this Exchange's Board of Directors over the past three months.

At its regular meeting on January 7, the Board:

- . Approved a two-phase test linkage between the ITS and the CAES.
- . Determined that the test would be composed of two combined elements:
 - an electronic linkage between the ITS and the CAES; and
 - trading conducted subject to an internalization rule that would be developed by the ITS Exchanges, the NASD and other industry groups.
- . It was further determined that the Securities Industry Association should be requested to undertake the coordination effort necessary to develop the internalization rule.
- . Phase I of the test would permit all trading in the 30 most active 19c-3 issues through the electronic linkage and subject to the internalization rule.

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- periodic "evaluation" reviews would be scheduled at the outset of the test and changes made, as required.
- an evaluation of the policy, rules and regulations needed to assure a fair field of competition among markets and market participants ("equal regulation" evaluation) would be initiated.

Phase II of test would reflect any necessary refinements to the internalization rule, the operational experience gained in Phase I and any agreed upon "equal regulation" type rule changes.

- the test would be expanded to include all 19c-3 stocks.
- the "equal regulation" evaluation would be completed during Phase II and any necessary rule changes would be put in place.

In addressing the NASD's request, the Board has reaffirmed the NYSE's position that all markets -- both exchange markets and "off-floor" markets -- must be integrated in order to achieve a truly effective National Market System. The Board, on the other hand, believes that its overriding responsibility in addressing the details of any plan for integration of exchange and "off-floor" markets must be to assure that integration is achieved in a manner that strengthens our nation's securities markets as required by the Securities Acts Amendments of 1975.

Recognizing a need for a prudent course of action and, given the reality that exchange markets and "off-floor" markets are vastly dissimilar and are characterized by trading techniques and patterns peculiar to each, the Board has determined that a test linkage represents a proper first step.

The Exchange believes that connecting the interlinked exchange auction markets (ITS) with "off-floor" dealer markets represents the most sensitive and difficult task of all in creating the National Market System (NMS). It is essential that the integration be achieved in a manner and under conditions that will advance the NMS objectives articulated by Congress, rather than jeopardize or destroy them. As the Exchange has pointed out on other occasions (see, for example, the Exchange's response, dated August 31, 1977, to Securities Exchange Act Release No. 34-13662 and its written statement and addendum dated June 29, 1979 filed with the Commission in response to

the proposal to adopt Rule 19c-3), Congress strongly endorsed exchange auction market principles and the investor protections and benefits flowing therefrom. Specifically, Congress called for the creation of a National Market System which, among other attributes, would assure the opportunity for investors' orders to be executed without the intervention of a dealer. In the NMS envisioned by Congress, customers' orders would interact to the maximum degree practicable and market-makers, where necessary to provide executions, would be permitted to compete fairly for all order flow.

"Internalization" is the term commonly used to refer to the practice by broker-dealers, of withholding their customers' orders in listed stocks from any market center (this Exchange or any other) and executing those orders in their own offices. Thus, the intercepted orders are not permitted to interact with other orders, and no market-maker or market center is allowed to compete for the intercepted order flow.

Internalization has been perceived to be an undesirable characteristic and one which is fundamentally inconsistent with NMS objectives. Testimony during the public hearings on proposed Rule 19c-3 in June 1979 pointed to the problems created by internalization. The Commission has also recognized the dangers of internalization. As the Commission has pointed out, the chief benefit to be derived from a National Market System is to:

"...capture and reflect all buying and selling interest in the securities traded in that system from moment to moment (thus exposing all buying interest to all selling interest) to the maximum extent possible so that all orders within the system can be satisfied in a manner consonant with the principles articulated by the Congress in Section 11A of the Act." (Securities Exchange Act Release No. 34-14416 (January 26, 1978) at 9, Note 15).

Furthermore, the Commission has recognized:

"If member firms acting as dealers are permitted to 'internalize' their order flow in reported securities (i.e., to execute their customers' orders in those securities as principal over-the-counter), such dealers would be able to insulate those orders from direct exposure to the buying and selling interest of other market participants (since such participants would lose the ability to intercept and achieve executions against such order flow by outbidding or out-offering prices offered by such dealers)." (Securities Exchange Act Release No. 34-13662 (June 23, 1977)).

Most recently, in its release announcing the adoption of Rule 19c-3, the Commission repeated its view:

"that an ideal configuration of a national market system would effectively preclude internalization by exposing orders, to the greatest extent practicable, to all buying and selling interests wherever located in the system." (Securities Exchange Act Release No. 34-16888 (June 11, 1980)).

The Exchange agrees with the Commission that, in the National Market System, broker-dealers with in-house order flow should be precluded from executing those orders as principal without first having exposed them to the buying and selling interests of other market participants in some meaningful way which is reasonably calculated to permit the customer to obtain the best execution currently available within the system.

Because proposed Rule 19c-3 seemed clearly inconsistent with fundamental National Market System objectives, the Exchange urged the Commission that it not be adopted until other basic issues were also addressed and, in particular, until effective measures had been taken to assure against internalization. While that advice was not taken and Rule 19c-3 was adopted without any accompanying rules to address the problem of internalization, the Exchange believes that this problem must be addressed before the process of testing an electronic linkage between the CAES and the ITS can proceed.

Specifically, the Board recommended that the Securities Industry Association undertake the coordination effort necessary to develop an internalization rule and that the views of the ITS participant exchanges, the NASD and the industry generally be sought as part of that process. In this regard, SIA Chairman Ralph DeNunzio, prompted by our request, has advised the Exchange that the Securities Industry Association has been authorized by its Board of Directors to undertake this important task. Of course, any rule proposal developed as the result of the SIA's efforts would be submitted to the Commission for approval.

The first phase of the two-phase test linkage would begin with trading conducted under the internalization rule. Phase I would include an electronic linkage between the ITS and the CAES with the 30 most active 19c-3 issues designated as the eligible securities. Periodic "evaluation" reviews of both the operational experience gained and participant experience under the internalization rule would be scheduled at the outset of the test period.

Appropriate changes in the internalization rule and the operation of the linkage, based on the experience gained in Phase I, would be implemented in Phase II of the test. Moreover, all 19c-3 stocks would be eligible for trading in Phase II via the electronic linkage.

A comprehensive evaluation of the policies, rules and regulations needed to assure fair competition among markets and market participants and the implementation of appropriate SEC and SRO rule changes are other tasks that should commence immediately and must be completed before the end of Phase II of the test. As that process identifies appropriate rule modifications, they should be promptly implemented.

Specifically, fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets must be thoroughly considered and assured to the extent practicable. On this matter, our Board has been strongly cautioned by its Market Performance Committee, its Institutional Traders Advisory Committee and its Upstairs Traders Advisory Committee -- the members of which are affiliated with those Exchange member firms most likely to engage in "off-floor" market making -- that appropriate minimum operational and financial standards for, and equitable regulation of, market-maker participants must be established so that properly balanced competition is achieved in a way that will inspire the confidence of investors and all participants within the National Market System.

In this regard, we specifically intend to evaluate, with the guidance of various Exchange advisory committees, those areas where existing market-maker regulation may be either competitively unfair or, indeed, inappropriate in furtherance of the purpose of the Act. We also intend to conduct a searching analysis of our own rules applicable to specialist activities to assure that they properly reflect the realities of the emerging competitive trading environment. By way of example, we intend to examine those NYSE Rules dealing with affirmative and negative obligations, market stabilization requirements, "tick" restrictions, handling of "not held" orders, options trading and other hedging restrictions.

With regard to the length of the test phases, it is the Board's view that the linkage and the internalization rule should be tested over a meaningful period of time so that a wide variety of trading situations and market conditions can be experienced.

The Board also recognized that all ITS participant exchanges should have an opportunity to develop their own automated linkages under the same or similar conditions and suggested that a plan for testing such linkages be established by the ITS Operating Committee.

The Exchange also believes that another basic issue remains to be resolved before full integration of the CAES into the ITS can occur. ITS participants are national securities exchanges, registered as such under the Securities Exchange Act of

1934. CAES is not. The Exchange has no knowledge of whether or not the CAES intends to register with the Commission as an exchange, or in some other capacity under the 1934 Act, or not at all. Mindful of its responsibilities under the 1934 Act in general, and, in particular, of the provisions of Section 3(a)(1), Section 5 and Section 19(g), the Exchange requests clarification from the Commission of its view of CAES' status under the 1934 Act.

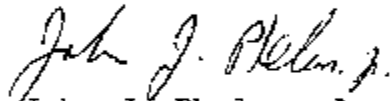
Obviously, the approach set forth herein is subject to review by all ITS exchanges and the NASD.

As stated previously, we feel that the matter of integrating exchange and "off-floor" markets represents the most difficult task in creating the National Market System.

The crucial considerations identified by the Board demand careful analysis by all of us who are concerned with keeping our markets strong, effective and responsive to the needs of investors.

I feel confident that we can expect all concerned to work together to assure that the objectives of the Securities Acts Amendments of 1975 will be met.

Sincerely,


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