

# Proposal For a National Market System



**Merrill Lynch Pierce Fenner & Smith Inc.**

The concepts, principles and structure of the National Market System described in this booklet are the culmination of two years of work by a task force of Merrill Lynch executives. This 15-man team was headed by Merrill Lynch vice president S.B. "Sandy" Lewis. Virtually every area of expertise at Merrill Lynch was represented on the task force including sales, marketing, law and compliance, electronics, communications, listed and over-the-counter trading and international operations.

PROPOSED MODEL FOR NATIONAL MARKET  
TRADING IN EQUITY SECURITIES

Introduction

This report sets forth in outline form a suggested Model whereby many of the concepts generally subsumed under the term "central market system" or "national market system" (NMS) can be put into operation in the securities industry at large. The Model consists of two principal elements: a set of rules and principles which would apply to the system as a whole and a summary of the manner in which securities firms such as Merrill Lynch would process orders in NMS securities. The Model can be implemented with existing technology. Although we recognize that construction of the proposed Model involves a substantial number of practical problems, it is our hope that by stating publicly Merrill Lynch's view of and support for such a system we may be able to contribute to hastening its development, testing and eventual implementation.

In designing the Model, we have reviewed the potential benefits which we believe would accrue to the investing public, the securities industry and the nation's capital markets upon its implementation. Obviously, to weigh these factors is a difficult undertaking because of the large number of variables involved. Nevertheless, it is our view that such benefits are sufficient to justify the effort and expense which construction of the Model would entail.

The Model is intended to safeguard and promote the desirable characteristics of the "auction-agency" market, which we believe are in essence threefold:

1) the prevailing principle for effecting transactions is price priority, i. e., securities generally will be sold to the highest bidder and bought from the lowest offeror; 2) opportunity is provided for investors to trade with one another without the intervention of a dealer whenever possible; and 3) competition in furnishing services to investors, including market making services, is to be encouraged, consistent with applicable regulatory principles.

As we conceive it, the Model will provide for considerably more varied competition, particularly in market making, than the present system does. Because of our broad support for competitive principles generally, and our knowledge of the undesirable effects that monopolistic practices can produce, we believe that the results of increased competition in market making will be beneficial for all concerned, particularly the investing public and, indirectly, users of the capital-raising mechanism.

We also believe that by providing broader access to the broker-dealer and market making functions, the Model will attract additional investment capital to the industry at a time when the need for such capital is great. By furnishing enhanced opportunities for profit in a wider range of activities, the Model may induce firms not now engaged in the securities business to invest in the business and may enable firms presently so engaged

to attract and invest more capital. In fact, we believe that in the final analysis the ability of the Model to attract capital will be an important condition of its success.

Finally, and perhaps most importantly, we, as a member of the securities industry, believe our responsibility to our customers requires us to develop and utilize the sophisticated systems capabilities and know-how we possess to fulfill our duty to make reasonable efforts to obtain the best execution of each order entrusted to us. If we and other members of the industry do not do so, it will simply be a matter of time before someone else devises a more effective and efficient method of trading securities, and we and the rest of the industry will be left behind.

#### Rules and Principles

The Model is based on a number of critical rules and principles by which the process of securities trading is to be governed in the future. They include the following:

1. Commission rates for transactions in equity securities will be competitively determined. Effective May 1, 1975, the SEC adopted Rule 19b-3, which prohibits the fixing of commission rates for executing exchange transactions. The Securities Acts Amendments of 1975 amended the Securities Exchange Act to reinforce this prohibition. Although the door has been left

open by the Amendments for the SEC to reimpose fixed rates if necessary, we believe the probability of this occurring is small, and we believe future planning realistically must contemplate a competitive rate environment.

2. All members of the NMS will be subject to "equal regulation" in accordance with the functions they perform. This principle is intended to ensure that firms which engage in the same kinds of activities will be governed by very similar, if not identical, rules, regardless of their self-regulatory affiliations; however, firms engaged in different activities will be subject to appropriately different rules. For example, firms which act as market makers may be subject to capital requirements quite different from those applicable to firms which merely perform routine broker-dealer functions. By the same token, market making firms which hold limit orders for customers may be regulated somewhat differently from those which elect not to.

Also implicit in the notion of equality of regulation is the principle that participants in the system should share its regulatory and operational costs in proportion to their use of its facilities.

3. Each member of the NMS must be a broker-dealer registered under the Securities Exchange Act of 1934, although it may be affiliated with a non-bank financial institution or a foreign entity. This principle raises the dual questions of "institutional membership" and "foreign access". With regard to the former, it appears that Congress and the SEC have concluded that a broker-dealer's affiliation with an entity engaged in a non-securities line of business should not disqualify that firm from stock exchange or NMS membership, subject to pervasive restrictions on the ability of all exchange members to

execute exchange transactions for their own account. A possible exception to this general principle may be the recognition that commercial banking activities should be separated legislatively from brokerage activities.

Foreign access raises a much more difficult question -- one with which the SEC has yet to come to grips, notwithstanding its solicitation of public comments on the subject well over a year ago. It is widely recognized that competitive rates provide foreign entities with a means of economic access to exchanges, regardless of whether they choose to become members; thus, there appears to be no practical means of limiting their participation in the NMS. Although participation by these entities may raise difficult regulatory problems, it seems clear that these alone are not sufficient to exclude them entirely from participation in the system.\* On the positive side, active participation by foreign entities in the securities business could provide a much needed source of investment capital for the industry. This capital could play an important role in contributing to the long-term vitality of the U.S. capital markets and could help ensure that those markets remain the strongest in the world. In fact, it is not unrealistic to envision the U.S. serving as a central market for international securities trading.

4. All transactions in listed securities in which a broker-dealer or "institutional investor" participates will be required to be executed within the NMS. This would mean that all such transactions will be subject to the trading

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\* One way to address these regulatory problems might be to require that any member of the system controlled by a non-United States person, as a condition of such membership, be required to agree to permit access to its pertinent books and records for the purpose of inspection and surveillance by appropriate United States regulatory authorities.

rules of the NMS and will be reported on a composite tape, except for certain transactions such as underwritings, option exercises, error offsets and the like. The only transactions which will be exempt from the rules of the NMS will be those between "individual" investors where no broker-dealer is involved. All other transactions will be subject to whatever obligations may be imposed in respect of clearing the book, disclosure, "best execution" and other matters. This is, in effect, a comprehensive type of off-board trading rule for the entire NMS and is essential to the system's integrity.

5. There will be a centralized communications facility capable of receiving, validating, processing, storing, displaying and cancelling a variety of inputs (such as orders, quotations, indications of interest, etc.) from all members of the NMS. This facility would be designed so as to be compatible, to the maximum extent possible, with communications equipment and systems utilized by individual firms. Its operating costs could be paid for by a transaction fee imposed on all users of system facilities, which might be based on volume or some other measure of utilization. The communications facility would be operated by a technically oriented body, such as a user-controlled corporation.

6. All bids and offers containing price and size information entered into the NMS will be available for viewing by any market maker and by any member under certain circumstances. This principle would cover bids and

offers entered as agent on behalf of a customer or for the member's own account. All such bids and offers, taken together, will constitute the "book". No system member would be obliged to place orders in the book, although not doing so would require that he protect his customers' orders in some other fashion.

We recognize that some valid arguments exist for not exposing the book to public scrutiny, even indirectly. For example, it is said that disclosure could discourage investors from placing such orders and, more importantly, could produce a detrimental effect on public confidence in cases where few, if any, bids for a particular stock may exist. On the other hand, exposure of limit orders would not disclose the identity of the investor, so that his anonymity could be preserved. Furthermore, the desire to secure price protection frequently would outweigh an investor's reluctance to tip his hand. Insofar as public confidence is concerned, we are doubtful that members of the public would react irrationally to knowledge of the book.

Perhaps a more compelling reason for requiring that bids and offers be made available, at least to system members, is the need to permit the operation of NMS rules regarding price priority (referred to below). In other words, it would be difficult to impose a requirement that all transactions "clear the book" if the firm executing the transaction is not in a position to determine the size of the interest which must be satisfied.

The SEC's "white paper" on a central market system, released in March 1973, suggested a compromise: limit orders would only be disclosed on a "need to know" basis. That is, a member could only learn what orders existed on the book after inserting into the system a description of the transaction he proposed to execute. Such a procedure could be subject to abuse, although it might be possible to devise measures to limit such abuse. This proposal may offer a workable alternative to full disclosure to all system members.

In addition, it probably would be desirable to permit all market makers in a given stock to view the entire book in that stock given the risks and responsibilities they must bear.

7. All orders or quotations containing price and size information entered into the NMS will be capable of being "hit". This principle would enable any member of the system to create a binding obligation on the part of any other member who has inserted an order or quotation to execute a transaction within the price and size parameters shown. For example, if a member inserted a bid of 25 for 300 shares of a particular stock, another member would be able to create an obligation on the first member's part to buy up to 300 shares of stock from him at a price of up to \$25 per share. This capability is essential to development of the "locked-in trade" or "automatic execution" capability described in more detail in the next section of this proposal.

8. All trading in the NMS will be subject to uniform rules establishing price priority, time priority (for orders at the same price) and precedence for public orders over those of NMS members (at the same price). The priority rules, which are similar to the "auction trading" rule proposed in the SEC's white paper, will require that there be an electronic book in which all limit orders can be stored, regardless of where they are originated, and thus given systemwide protection. The rule giving precedence to public orders corresponds to the SEC's proposed "public preference" rule.

It has been suggested by some commentators that orders of individual investors be given preference over those of institutional investors at the same price. Presumably, this would be done in an attempt to redress part of the apparent trading inequity between large and small investors and perhaps to restore some of the confidence small investors are said to have lost in their ability to share the trading advantages possessed by large investors. It should be remembered, however, that institutional investors often represent, in aggregate form, the smallest and least affluent investors -- such as pensioners -- and that it might be unfair to place them at a handicap. Thus, we believe investors of all sizes should receive equal treatment within the auction pricing system.

9. There will be no limitation on the number of NMS members permitted to make a market in any NMS security, although an exchange would be free to limit the number of market makers trading on its floor in any given security.

This principle would permit each exchange to determine for itself whether it wished to retain a "specialist" on its floor in some or all securities or whether it wished to permit competition on its floor, as the CBOE has done. In no event, however, would an exchange be able to prohibit its members from quoting two-sided markets off the floor of the exchange; i. e., off-board market making would be permitted. Thus, the monopoly of the specialist would be effectively terminated, and all NMS members would be given an opportunity to engage in market making activities, assuming their willingness to comply with whatever additional requirements may be imposed on market makers.

10. No market maker will have any affirmative obligation to make a continuous market in a stock, although market makers will not be permitted to enter and leave the market for a stock at will. In view of our conclusion that the specialist's monopoly role should be eliminated, it would appear to be unfair and unnecessary to impose an affirmative market making obligation on firms engaged in market making. It often is said that this monopoly, particularly when coupled with floor brokerage income from holding limit orders, provides a subsidy to the specialist which induces him to provide a continuous market in stocks even when it otherwise would be unprofitable for him to do so. It is our belief, however, that this subsidy system is inefficient and unenforceable. In effect, it is difficult or impossible to require a firm to risk its capital in market making activities when the firm is reluctant to do so.

Nevertheless, to prevent firms from lightly undertaking a commitment to make a market in a particular security there should be a requirement that in order to begin quoting a stock a firm would have to agree to continue to provide two-sided quotations in that stock in a given size <sup>\*</sup> for a minimum period, such as six months. It also may be desirable to impose a one-time fee for commencement of market making activities without a genuine commitment. Moreover, market makers clearly must be subject to regulatory oversight in the form of minimum capital requirements and enforcement of trading restrictions (such as those now in effect) which prevent them from taking advantage of their position through improper trading practices.

11. Limit orders will be inserted into the system by brokers directly and will be stored and displayed through system facilities without any charge for floor brokerage. Under the Model there would be no reason to funnel all limit orders through specialists, nor would there be any reason to pay compensation to any NMS member for seeing that such orders are executed. Limit orders would be entered into an electronic repository by brokers (through

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\* Minimum quotation size might vary, depending on the liquidity of the particular stock. Securities eligible for trading in the NMS could be grouped into categories based on their liquidity (as measured by total capitalization, number of shares outstanding, number of shareholders, trading volume, etc.). In the most liquid category, market makers would have to make their quotations good for a minimum of at least, say, 500 shares; in the least liquid category, quotations would have to be good for at least one round lot. Stocks would be able to move from one category to another periodically as their trading characteristics changed. A graduated system of minimum quotation sizes such as that described would make it possible to execute a 500-share order of an active stock at a single price.

individual salesmen or through order rooms), and such orders would be cleared automatically. If thought desirable, a small service fee might be imposed on limit orders by the NMS authority itself, but this would be no different from any other service fee based on usage of system facilities.

12. Market makers will not be prohibited from dealing directly with institutional investors. In the early 1960's the SEC concluded that the specialist's discretion in matching orders presented him with an opportunity to favor his own customers over those whose orders were forwarded by another firm and recommended that specialists be prohibited entirely from carrying accounts for direct customers. A compromise was reached, allowing the specialist to carry public customers' accounts but prohibiting him from carrying the accounts of corporations in whose stock he specializes and their insiders, as well as accounts of institutions generally.

Despite their regulatory origins, NYSE Rule 113 and Amex Rule 190 have come to serve as cornerstones of the present exchange system by imposing, with the assistance of off-board trading rules, a separation between market making and brokerage functions. These rules also place specialists at a competitive disadvantage as compared with block positioners by insulating them, to some extent, from indications of institutional buying and selling interest and the "feel" of the institutional market in a stock, notwithstanding their possession of the book, which seldom contains orders of substantial size.

In a NMS in which competitive market making is contemplated, the regulatory basis which originally prompted the adoption of these rules no longer will exist since the specialist will lose his monopoly position. In addition, it is not feasible to leave the present rules in effect since it would be unfair to expect specialists to compete with off-board market makers if they were deprived of access to a critical source of business and information. Insofar as the question of applying similar rules to all market makers is concerned, it would be impractical in the Model to prevent market makers from dealing with their institutional customers, since a principal reason for their market making activities would be to attract such customers. Further, under competitive rates it would be relatively easy for institutions, if prohibited from direct dealing with market makers, to engage brokers to represent them in transactions which they themselves have negotiated directly with market making firms and to pay such brokers a minimal commission rate for their nominal services.

#### Scope of System

The Model is intended to strengthen auction trading, which currently exists only for listed securities. Perhaps for this reason, most existing plans for a NMS have been limited to such securities. We believe it would be well to consider whether a distinction between listed and unlisted securities is appropriate on a long term basis.

It is generally acknowledged that only relatively liquid securities -- those in which there is a substantial amount of investor interest -- are appropriate for auction trading. Obviously, a number of presently listed securities may not be suitable for auction trading, while many unlisted securities would lend themselves to such trading.

The Model contemplates eligibility for all securities which have trading characteristics that make them appropriate for auction trading, regardless of whether or not they are listed. As the NMS develops, the existing line between listed and unlisted securities likely will blur and may eventually dissolve.<sup>\*</sup> As this occurs, the eligibility standards of the NMS should be modified to permit the trading of all suitable securities without regard to their listed status.

Whether or not unlisted securities are to be traded in the NMS, there will be a need to provide for trading of securities which are eligible for inclusion in the NMS but which do not have the requisite characteristics to support auction trading. At the present time, securities listed on the NYSE which trade inactively are assigned to Post 30, where the specialist is not required to

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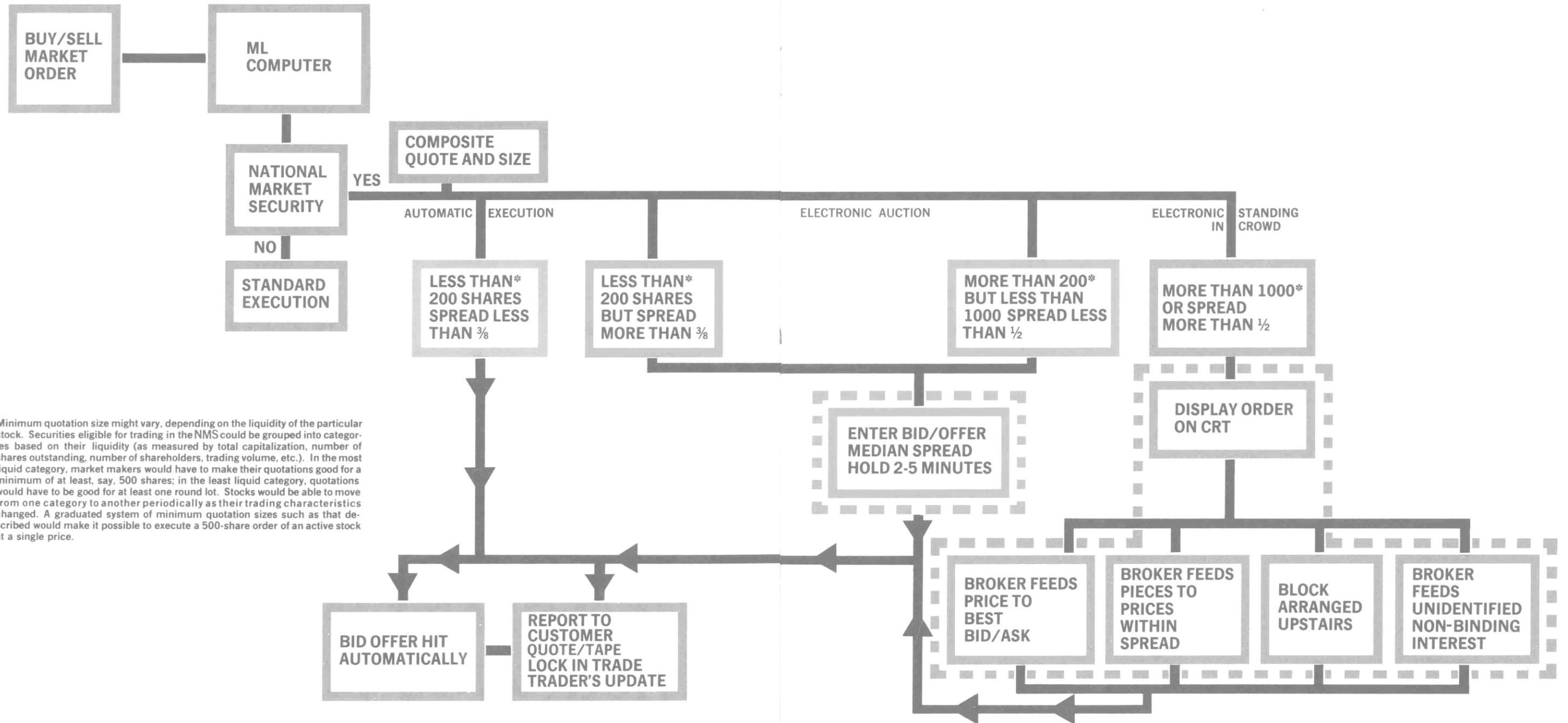
\* Some evidence of this likelihood is provided by the amendments to Section 12(f) of the Securities Exchange Act which, under certain conditions, would permit exchanges to grant unlisted trading privileges to securities not listed on any registered exchange.

deal in them for his own account but merely to record all bids and offers and to execute trades for brokers when there is a bid and offer at the same price. We believe a similar principle should be applied in the NMS: the system simply would maintain a file of bids and offers in inactive securities and would notify members when there is a match.

A procedure would have to be established to determine when a stock should be relegated to inactive status. For example, if a security had only one market maker assigned to it and that firm gave, say, three months' notice to the NMS of its intention to cease market making activities, other members of the NMS could be given an opportunity to request assignment of the security. If no requests were received, the security would be designated "inactive" at the end of the three-month period and would be traded as described above until investor interest were renewed to the point where market makers found it desirable to request that it be assigned again. Thus, securities could move from active to inactive status as conditions warranted with relative ease. Since the securities would not, in any sense, be removed from the NMS, the effect on investor confidence presumably would be minimal.

#### Individual Firm Operations

The actual process by which an order entering a brokerage firm would be executed, depending on the size of the order, market conditions and other factors, is best described by means of a diagram (see Chart I) viewed in



\* Minimum quotation size might vary, depending on the liquidity of the particular stock. Securities eligible for trading in the NMS could be grouped into categories based on their liquidity (as measured by total capitalization, number of shares outstanding, number of shareholders, trading volume, etc.). In the most liquid category, market makers would have to make their quotations good for a minimum of at least, say, 500 shares; in the least liquid category, quotations would have to be good for at least one round lot. Stocks would be able to move from one category to another periodically as their trading characteristics changed. A graduated system of minimum quotation sizes such as that described would make it possible to execute a 500-share order of an active stock at a single price.

conjunction with the following discussion of the manner in which such a firm could structure its order execution operations.

1. Order Algorithm. The firm's computer will identify the security named in each order entering its order execution system (OES) to determine whether it is a NMS security. If not, it will be sent on for execution in the usual manner; if so, it will be processed within the NMS. Orders processed in the OES will be handled differently, depending on such factors as the order's size, the depth and spread of the public market in the security at the time of entry and the firm's position in the security, if any, at the time of entry. These criteria will be built into the OES as a predetermined formula or "order algorithm" but will be capable of modification at any time.

The Model is designed to permit automatic execution of a maximum number of small, routine orders in securities where a liquid market exists, but also provides for the exercise of human brokerage judgment whenever it appears that a satisfactory execution (as defined by the order algorithm) is not immediately available. In addition, the Model permits utilization of the NMS's communications network to carry out various trading strategies similar to those employed on an exchange floor. These features of the Model are outlined below.

2. Automatic Execution. As contemplated by the Model, orders of less than a predetermined size, including odd lot orders, <sup>\*</sup> will be capable

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\* Odd lot orders would be executed in the same manner as round lot orders (i. e., against the best bid or offer available, rather than at the next sale), except that, because of their lesser significance, odd lot transactions would not be printed on the tape.

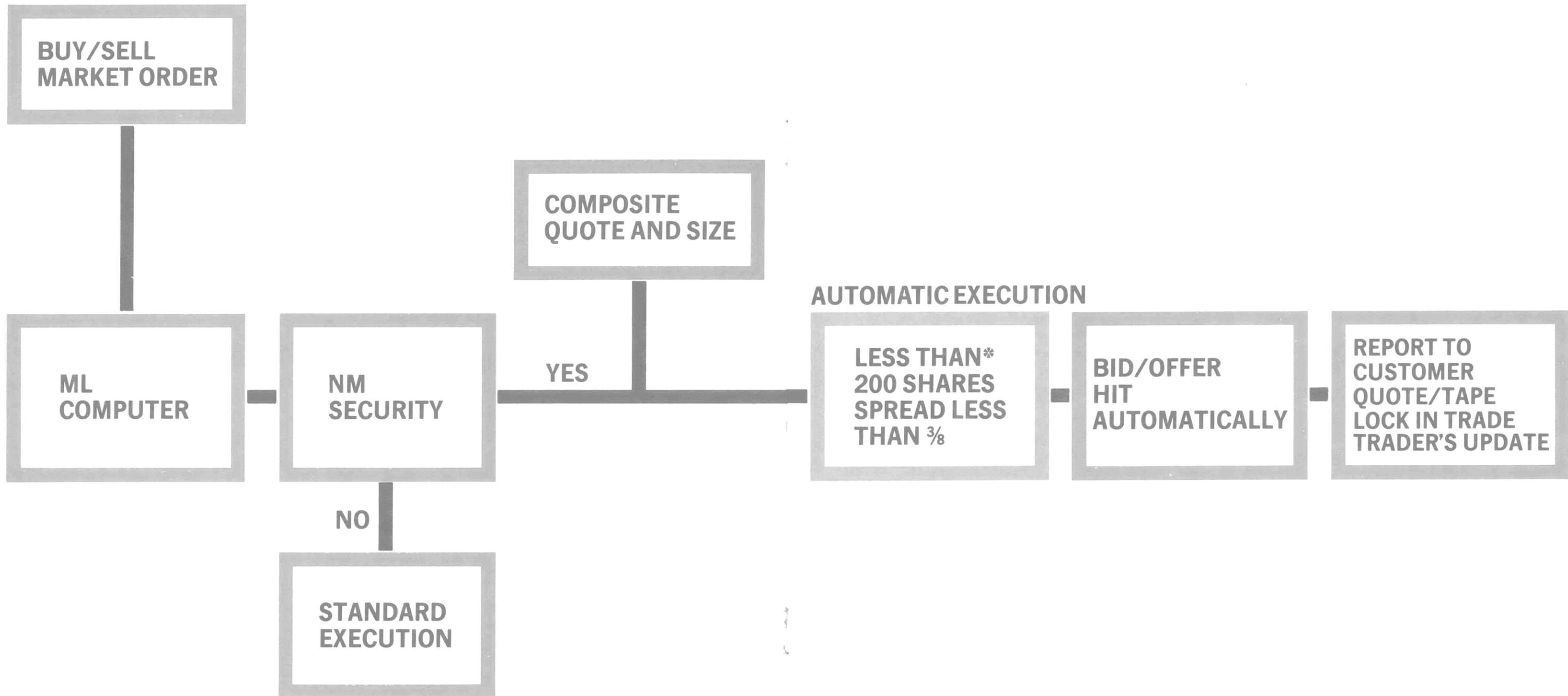
of being executed automatically against the best bids or offers publicly displayed (see Chart II). When an order in a given stock arrives, the computer will determine whether it is for less than the maximum number of shares designated for its category of liquidity (for example: in an active stock, whether the order is for 500 shares or less; in an inactive stock, 100 shares or less). If so, the computer will check the public market in the stock -- that is, the spread resulting from the best available bids and offers in sufficient size to accommodate the order. \* If the spread is too large (for example, over 3/8), the order will be handled by means of the "electronic auction", discussed below. If it is not too large, it will be automatically executed against the best bids or offers represented in the public market; however, if the firm has an interest in the other side (for example, if the block trading department is working off a substantial long position at the time a buy order in the particular stock comes in), the order could be executed against the firm's own position at a price at least as favorable to the customer as the best price then available in the public market (or more favorable, if a rule is adopted establishing preference for public orders).

Once the order is executed, the OES will automatically prepare a report to the customer, send a message to the composite tape, \*\* update the firm's

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\* There might be public bids or offers at prices better than the market maker's quotation, but such bids and offers would not be subject to the same minimum quotation size requirements.

\*\* Except in the case of odd lots.



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position and quotation, if any, and notify the clearing house and cashier's department, as appropriate. Thus, the trade will be "locked in".

3. Electronic Auction. This feature of the Model (see Chart III) is designed for orders for which the order algorithm has determined that some attempt should be made to improve the execution available in the existing public market as shown on the composite quotation display. Generally, these will be orders of medium size (perhaps between 100/500<sup>\*</sup> and 1,000 shares), as well as small orders where the public spread was too large for automatic execution; however, this feature will not be utilized where the public spread is excessive (say, greater than 1/2) and is not designed for orders of block size, which will be handled separately.

The electronic auction attempts to simulate what can take place in the auction crowd on the floor of an exchange. It automatically inserts a bid or offer into the NMS which improves the existing public market (perhaps at the median between the existing bid and offer). Such bid or offer is shown in the NMS as a firm order, capable of being "hit", for a fixed period of time (e.g., five minutes). If hit, the order will be handled as in the case of automatic execution, described above. If not hit within the prescribed time, the order then will be executed automatically against the best bid or offer available at the time in the public market.

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\* Depending on the category of liquidity in which the stock falls.

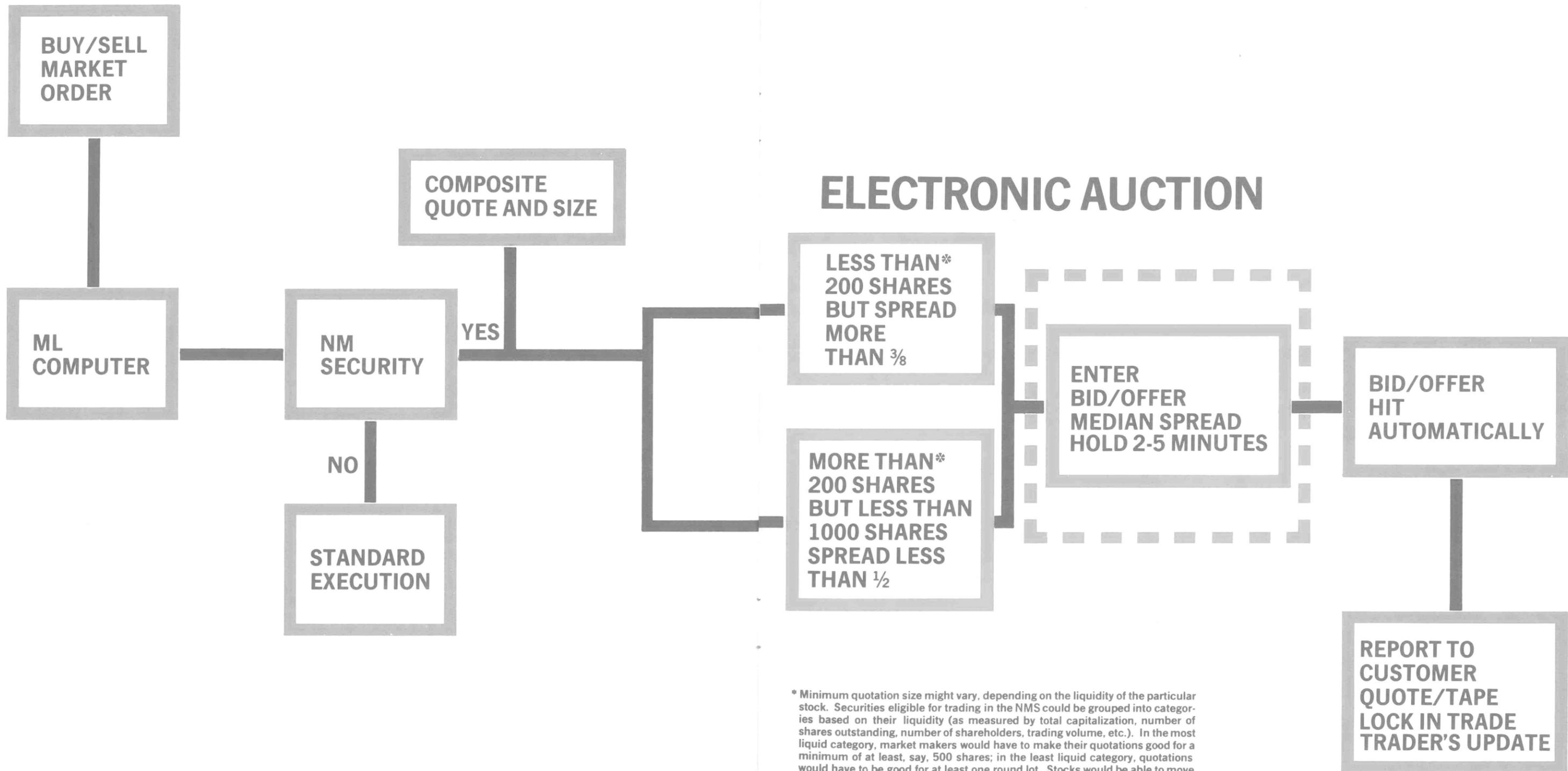
This feature is based on the hope that the improved bid or offer will attract a seller or buyer who has been watching the market in that stock, as sometimes happens in an exchange crowd. It is recognized that by seeking to improve the customer's execution in this manner a broker runs the risk of missing the best bid or offer which was available when the order arrived, unless a "stopping" procedure is devised. To protect the broker from liability in such a case, there should be a clear understanding with the customer in advance whether he wishes his broker to take the market as he finds it or to seek to improve the execution, notwithstanding the foregoing risk.

4. Electronic Standing in the Crowd. The Model contemplates special treatment for an order not capable of execution automatically or by means of the electronic auction feature (see Chart IV). Such an order -- either a large order (say, over 1,000 shares) or a medium size order where the public spread is too great -- will be flashed to a CRT screen constantly monitored by an experienced broker (trader). The broker then will have the option to handle the order in a variety of ways:

1. He may send the order back for automatic execution, notwithstanding its size and the existing spread;

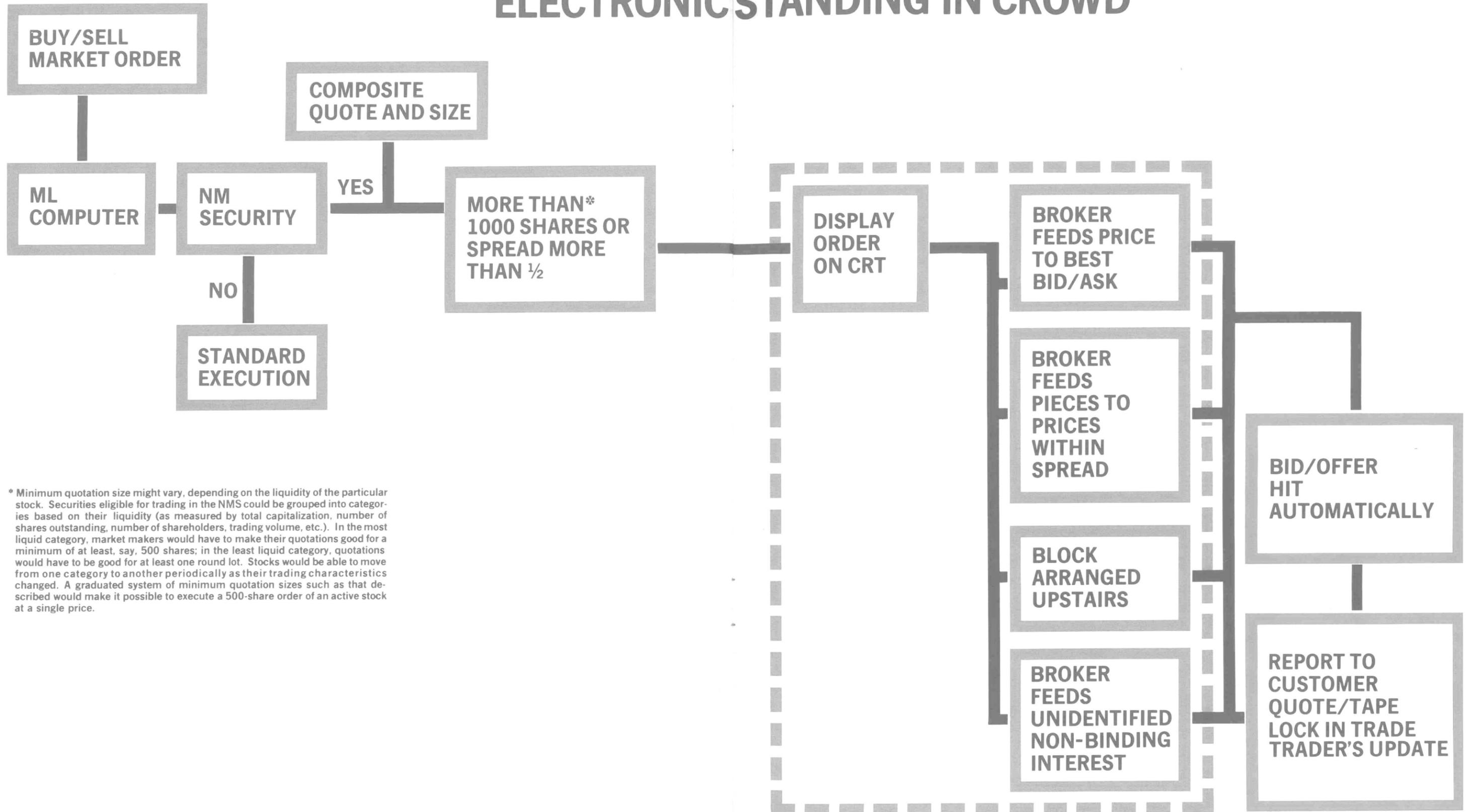
2. He may try to arrange a cross, as a block transaction would be handled today;

3. He may handle the order on a piecemeal basis by sending small portions of it to the public market for automatic execution against the best bid or offer represented in the NMS;



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# ELECTRONIC STANDING IN CROWD



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4. He may handle the order on a piecemeal basis by means of the electronic auction procedure described above, bidding for or offering small portions of the order at prices which improve the public spread; or

5. He may insert into the NMS an anonymous indication of interest by means of a procedure which will enable him to be notified of any potentially offsetting indications of interest. (For example, he might insert a message that he is a potential buyer in size of XYZ. The message might or might not be displayed (at his option) but in any event would not indicate who inserted it. Thereafter, if another NMS member inserted a message indicating he is a potential large seller of XYZ, each would be notified of the other's interest. An anonymous negotiation would then occur, and if agreement on a trade were reached, each side would be notified of the other's identity.)

The last three alternatives attempt to simulate in some respects the options available to a broker standing in an auction crowd on an exchange floor, hence the term "electronic standing in the crowd" for this feature.

When the order is finally executed by means of one or any combination of the preceding techniques, it can then be processed through the OES in the same manner as in the case of the automatic execution procedure.

## Governance and Regulation

The subject of governance and regulation may be divided into two temporal segments: first, the transitional period from the present until such time as a full-fledged NMS is in operation and, second, the period thereafter. The first involves the means by which a NMS can be developed, tested and implemented. The second relates to the method of regulating the NMS once it is in operation.

1. Tasks to be Performed by Governing Bodies. In this section, we consider the duties which must be performed during the two stages covered by our inquiry and suggest which bodies might best discharge them.

A. Transitional Period: Development of NMS. The first question to be faced by the industry and its regulators is how to develop an efficient, workable NMS. The principal elements of the development process are (1) design of the components of the system and (2) promulgation of the rules which will be applicable to its operation.

The first category includes the design, from a technical viewpoint, of such complex configurations of hardware and software as the composite quotation system, the central electronic limit order repository, the system for automatically locking in trades and related systems. It seems apparent that Congress intended at least part of this design function to be within the province of the National Market Advisory Board established by the Securities Acts Amendments of 1975. Their efforts will have to be supported by

technicians and other experts from such organizations as SIAC, NASDAQ and perhaps the exchanges. The SEC obviously will keep a careful eye on these matters, but because of the complex technical questions which are inherent in the design of such a system, it can be expected that the Commission probably will play a residual role, helping to resolve disputes and to apply pressure when necessary to work out a solution. The amendments require that the Board present its final recommendations to the Congress, not the SEC.

The second principal component of the development process will be the promulgation of rules to regulate the workings of the NMS. Such rules might include, for example, an auction trading rule, a public preference rule, a set of standards for market making and related subjects. Although the Advisory Board probably will attempt to put forth recommendations on such rules (as the Yearley Committee has attempted to do) only the SEC can adopt them. It seems clear that the Commission not only will have the final word on NMS rules but also will take the initiative on many of them. All rules which are promulgated by the Commission must be exposed for public comment; thus, it can be expected that existing self-regulatory bodies, broker-dealers and others also will furnish substantial input.

Although most of the development plans in both the above categories probably will be the responsibility of the Advisory Board and the Commission,

assisted by the self-regulators, we believe individual firms acting in concert can and should have a substantial impact on the formulation of such plans.

B. After NMS Operational: Supervision of NMS. Once the NMS has reached the operational stage, the role of the Advisory Board should be substantially completed. The question will remain, however, whether a new body or bodies are needed to supervise and regulate the ongoing operation of the system, or whether those functions can be adequately performed by those self-regulatory bodies already in existence, or some combination of those bodies.\* It should be noted that the Securities Acts Amendments afford the Commission ample authority to combine or allocate as it sees fit the various regulatory responsibilities exercised by the self-regulators.

It is useful analytically to view the components of the ongoing supervisory function as threefold: (1) supervision of central market trading, (2) supervision of compliance with general regulatory requirements, and (3) performance of service functions.

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\* This is a question to which the Advisory Board is to address itself.

(1) Supervision of central market trading will include application and enforcement of such matters as trading practices in general. Because such matters are closely related to the particular market centers in which questions arise, it would appear that each market center is best situated to apply and enforce rules with respect to trading within its own sphere of activity, either independently or on behalf of a systemwide self-regulatory body with authority to delegate supervisory responsibilities throughout the NMS. Thus, for example, the NYSE could continue to regulate trading on its floor and the NASD could continue to supervise over-the-counter trading. On the other hand, to the extent intermarket questions arise, they would best be resolved by the systemwide body. This organization could be the Commission or could be some sort of ongoing central market body, which could resolve such questions subject to the residual supervision of the Commission. Such a body should be comprised of representatives from the industry at large, however, rather than from individual market centers, to insure that issues are resolved on the basis of the broadest considerations. Depending on its composition and performance, it may be desirable for the Advisory Board to evolve into or be replaced by such an organization.\*

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\* The "National Market Regulatory Board" referred to in Section 11A (d)(3)(B) of the Securities Exchange Act could be established to deal with intermarket questions.

(2) General regulatory compliance will include such matters as application and enforcement of capital rules, recordkeeping requirements, registered representative standards and similar strictures, particularly those concerning the broker-dealer's relationship to its customer. Because of the breadth and variety of its membership, its national organizational structure and its past experience, it has been suggested from time to time that the NASD may be ideally suited to perform this task in the future. Others have suggested that the NYSE might be best equipped to do so. Assigning the general compliance function for all NMS members to a single organization could eliminate duplicative regulatory activity, such as inspections, and could produce cost savings.

(3) The various service functions which are necessary to support the system include clearing, settlement and depository functions; back office accounting; and operation of the communications systems which underlie central market trading, i. e., the composite tape, the composite quotation system and the limit order repository.

A distinctive aspect of these service functions is that traditionally they have been revenue-producing, whereas supervisory and compliance functions generally tend not to produce revenues. Perhaps for this reason, the market center which has been most active in providing service functions (the NYSE) has been able to maintain a relatively elaborate compliance program. At least in theory, however, there is no reason why this need always

be so, if an equitable means can be devised for diverting revenues produced by the various service functions to the entities that are performing the compliance functions. This, too, clearly is within the scope of the Commission's authority, as enlarged by the Securities Acts Amendments.

Because of the potential revenues to be derived from performance of service functions, it would be unfortunate to abandon this field entirely to privately-owned vendors and other entrepreneurs if the tasks could be performed by user-owned and -operated service corporations. For example, if an organization such as SIAC could be spun off and owned directly by members of the industry, it probably could ensure that a considerable proportion of service revenues are retained within the industry. We recommend that, to the extent possible and legally permissible, entities performing securities industry service functions be owned and controlled by members of the industry.

Finally, we note that the Securities Acts Amendments make it very clear that Congress has given the securities industry its "last clear chance" to put self-regulation to work. The Amendments give the Commission direct, rather than merely residual, authority to act in virtually all the foregoing areas if the industry fails to do so. Accordingly, we believe it is imperative that the industry assert appropriate initiative in these areas to prevent government preemption by default.

#### Pilot Program

As we noted in the introduction to this proposal, we believe the Model can be implemented with existing technology. Furthermore, most of the

equipment necessary for its operation not only is available from hardware manufacturers but actually is in place in most brokerage firms. Accordingly, we see no reason why experimentation with the Model, or some variation thereof, could not commence within a relatively short time period, perhaps one year.

One way of approaching such an experiment would be to select a group of, say, 25 stocks and to conduct a pilot program whereby those stocks would be traded in accordance with the principles outlined in our proposal. We recognize that it would be extremely difficult for such a pilot to simulate actual NMS conditions, but we believe a meaningful program could be devised to test the practicalities of NMS trading. Such a procedure would permit necessary adjustments and modifications to the Model to be made prior to its implementation on a broader scale.

#### Conclusion

It is our hope that by stating our proposal publicly we can hasten progress toward implementation of a national market system. Naturally, the most effective way to implement such a system would be for the leading firms in the industry, acting collectively (perhaps through the Securities Industry Association), to cooperate in its design and construction. Before this can occur, however, there must be general agreement among members of the industry as to fundamental principles of the system. Attaining such agreement will require discussion and vigorous debate. We believe it is time for such debate to begin in earnest, and it is our hope that our proposal can help it to begin.

In short, it would be folly for us to believe that our proposal could serve as a definitive statement on all the issues with which it deals. We recognize this and strongly urge all other members of the industry interested in participating in a workable national market system designed and built by members of the industry to respond to our proposal with constructive criticism, alternative proposals and other points of view. We also hope that the National Market Advisory Board, in discharging its duties under the Securities Exchange Act, will consider our proposal. For our part, we shall gladly undertake to assist the Board in any way possible.

Merrill Lynch, Pierce, Fenner & Smith Incorporated

October 16, 1975



**Merrill Lynch Pierce Fenner & Smith Inc.**