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January 28, 1977

Chairman Roderick m. Hills
Commissioner Philip A. Loomis, Jr.
Commissioner John R. Evans
Commissioner Irving M. Pollack
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

Re: Establishment of a Composite Limit Order Book

Dear Sirs:

In Securities Exchange Act Release No. 12159, dated March 2, 1976 (the "Release"), you stated that "the Commission intends to utilize its authority under the Act ... to facilitate the development of a composite book." [Footnote: Page 2. The phrase "composite book" is used herein with the same meaning as it is used in the Release.] In the Release you also stated that you were interested in "the comments of interested parties as to what other alternatives to a composite book system should be considered." [Footnote: Page 13] From the early stages of discussions about a national market system, various persons have suggested

that a composite book or some similar facility might be an important part of such a system. [Footnote: See, for example, Commissioner Phillip A. Loomis's statement on November 8, 1971, during the Commission hearings In the Matter of the Structure, Operation, and Regulation of the Securities Markets, at page 2329, and the statement of A. O. Becker & Co. Incorporated presented at such hearings on November 16, 1971, at page 12.] During the last five years the concept of a composite book has been discussed in many contexts and the concept has been significantly refined. [Footnote: See, for example, Securities Industry Study Report of the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, United States Senate, February 1973, at page 112, and Reports of the Advisory Committee on the Implementation of a Central Market System dated September 12, 1975, pages 15, 78-83.] In fact, early in its deliberations, the Board singled out the composite book as one of the seven subjects it would study in assessing how a national market system ought to be established. Recent impetus for the Commission's taking action with respect to a composite book arose from discussions concerning the removal of restrictions on off-board trading by members of national securities exchanges. In your release on that subject you noted:

"Of all the arguments advanced in favor of retaining some form of off-board trading rule ... the most persuasive concerned the desirability of continuing protections for public limit orders ... it is clear, therefore, that the only fair, realistic, and practicable way of mandating satisfaction of public limit orders ... is through the creation and development of a composite book and the imposition of a requirement that all transactions, wherever and by whomever effected, must clear that book." [Footnote: Securities Exchange Act Release No. 11942 (December 19, 1975), pages 43-44.]

Most recently (pages 1 and 2 of the Release); you observed that a composite book would also enhance competition among market makers (both exchange and third market), link markets through communications and data processing equipment and provide for the more efficient handling of limit orders.

The Securities Exchange Act of 1934, as amended, (the "Act") assigns to the National Market Advisory Board (the "Board") the responsibility "to formulate and furnish to the Commission its views on significant regulatory proposals made by the Commission or any self-regulatory organization concerning ... the markets for securities in the United States." [Footnote: Section 11A(d)(2)] Perhaps even more important in this context, the Act directs the Board "to make recommendations to the Commission as to the steps it finds appropriate to facilitate the establishment of a national market system." [Footnote: Section 11A(d)(3)] Because any action taken towards establishing a composite book would be such a step, the Board is forwarding its recommendations with respect to the appropriateness of your taking such action.

The Board has discussed at length the issues related to a composite book and has received submissions from and consulted with many interested persons regarding these issues. Pursuant to the Board's statutory responsibilities and in response to your request, there are set forth below the views of the Board and the minority views of certain Board members resulting from such consultations and discussions.

CONCLUSION

The Board believes that the development of facilities which would provide protection of limit orders to the maximum extent practical is an important objective of a National Market System. [Footnote: The Board decided to use the phrase "protection of limit orders to the maximum extent practical" after considering various other formulations including "full protection." The Board felt that the latter would mandate the establishment of a composite limit order book, but that, in light of practical considerations, it should remain open for the industry and the Commission to consider alternatives that would achieve maximum practical protection but fall short of achieving full protection. Several members of the Board felt that available data indicate the technological and economic practicality of a composite limit order book as described below and, unless future evidence is to the contrary, that nothing short of such a composite limit order book should be accepted as protecting limit orders in a national market system to the maximum extent practical.]

The Board also strongly supports the idea that the industry be allowed the primary role in any effort to achieve this objective, as opposed to its being achieved by action mandated by the Commission. In its public deliberations, which have included oral and written presentations by several industry groups, the Board has discovered a wide range of industry feeling, from strong support to outright opposition to a composite book. At the same time, it is also aware of an organization, initiated by the Securities Industry Association, of representatives of seven stock exchanges and the National Association of Securities Dealers, Inc. (the National Market Association ("NMA")) which was formed to "analyze alternative methods for enhancing limit order protection, increasing competition between and among market places for listed securities, and increasing communications between and among such marketplaces ..." [Footnote: Quotation from press release issued on September 27, 1976. On that date representatives of the American, Boston, Midwest, New York, Pacific and Philadelphia Stock Exchanges and the NASD, formed the National Market Association. Subsequently, the Cincinnati Stock Exchange joined the association.]

The Board is aware of several proposals either presented to it or discussed by industry entities which, according to the various proponents, could provide an acceptable degree of protection of limit orders and increased competition among

specialists and market makers. The Board judged that the NMA within six months from its inception in September 1976, should be able to analyze alternatives to a composite book as well as agree upon a course of action.

In light of the significant industry interest in attempting to develop on its own a system of enhanced limit order protection, the Board voted to encourage the industry effort. At the Board's December meeting, the NMA appeared and described its progress to date as well as the prospects for further cooperative efforts towards development of an alternative to a composite book. The Board was impressed by the NMA's progress to date and by the expressions of unanimity among the NMA members of their determination to settle further specific questions in the near future. The Board expects to hear further from the NMA as they resolve outstanding questions.

Since it is not clear that a suitable alternative to a composite book can be found and agreed upon within the next several months and because, in the Board's view, a composite book, or some facility, arrangement or business practice which would achieve substantially the same ends is an important element of a national market system with respect to which action should be taken in the near future, the Board recommends that the Commission pursue its analysis and decision-making process with respect to a composite book while the industry efforts are proceeding. To assist the Commission in this effort, pursuant to the responsibilities of the Board under the Act and in response to your request, the Board has outlined its views with respect to various characteristics of a composite book and means of facilitating its development.

Because a number of the concerns relating to a composite book result from lack of knowledge regarding the exact consequences of establishing a composite book, the Board believes that pilot programs, developed either through private initiatives or through industry cooperation, would be quite useful to the Commission in its deliberations with respect to the composite book, and therefore recommends that the Commission actively encourage such initiatives and cooperation.

DISCUSSION AND ANALYSIS

A. Desirability of Protecting Limit Orders

As noted above, recently impetus for action to enhance the protection of limit orders has arisen from discussions relating to the removal of restrictions on off-board trading by members of national securities exchanges. An important objection to the removal of such restrictions was concern over the diminished protection of limit orders which might result. Thus an important advantage of developing a means of providing protection of limit orders to the maximum practical extent in a system composed of competing market centers is that, if the

removal of off-board trading restrictions were otherwise found to be desirable, they could be removed without fear of the possible consequences for limit orders.

More fundamentally, protection of limit orders to the maximum extent practical is a desirable objective in and of itself. Limit orders, which constitute a significant portion of the orders placed with respect to listed securities, not only serve a useful purpose for investors but also contribute to the strength and orderliness of the market. They provide depth and liquidity (i) by facilitating stabilizing trades (sales in rising markets and purchases in falling markets) at prices reasonably related to preceding trades, (ii) by facilitating the assembly of the opposite side of “block transactions”, and (iii) by narrowing the spread between the bid and asked. [Footnote: The degree to which limit orders serve these ends for the market in a particular security varies considerably among listed issues.]

Providing system-wide protection of limit orders would also help to reduce market “fragmentation” (in the sense of failure of the best bid to meet the best offer) by significantly reducing the possibility of a transaction occurring in any market at a price outside the spread of the limit orders in the system without satisfying the better bids or offers represented by such limit orders. Certain means of system-wide protection of limit orders could also serve to enhance competition by affording wider access to information about limit orders and a greater opportunity for specialists and market makers to compete in providing the other side of limit orders. Certain means could also increase the efficiency with which limit orders are handled through the increased use of data processing systems.

B. Concerns Relating to a Composite Book

Although the Board is of the view that a composite book could provide full protection of limit orders it believes that the Commission should be aware of certain concerns held by various segments of the industry as to possible adverse effects a composite book might have on the market.

First, there is the concern of some persons that New York Stock Exchange specialists will reduce their market making activity because they will no longer receive revenue for servicing brokers’ limit orders. Even if brokers were limited to using specialists or market makers for entering and executing of limit orders, such persons believe that the expected competition would reduce charges for these services to a level that contains little incentive for specialists assuming any affirmative market making obligations.

There is also concern by some that a composite book will lead to a system providing for direct execution by the broker, in effect by-passing exchange floors, and would eventually lead to the demise of exchanges and the workings of the auction agency markets as we know them.

There is the additional concern that the costs of developing a composite book would exceed the value of any benefits that might accrue to the industry or the public.

These concerns are discussed in some detail below in connection with the discussion of characteristics of a composite book. What is clear, however, is that we do not know the exact consequences of establishing a composite book and, in this regard, pilot programs which could be developed either through private initiatives or through industry cooperation and could receive coordination and supervision from the self-regulatory organizations might be useful in developing further information with respect to these concerns.

C. Reasons for Supporting Industry-Wide Effort to Develop Its Own System of Limit Order Protection

As a result of presentations made to the Board it judged that it might be possible for industry members working together to agree upon, by March 31, 1977, some alternative to a composite book which would meet the following four criteria: (i) protect limit orders to the maximum practical extent, (ii) provide for the more efficient handling of limit orders, (iii) link markets through communications and data processing equipment, and (iv) enhance competition among specialists and market makers. Even if this industry effort, carried on through the newly formed NMA, is not successful in agreeing upon an acceptable alternative to a composite book, it is possible that it might take the lead in organizing one or more pilot projects or in initiating the process of establishing a composite book, if it determined that this were the most desirable way to proceed.

The Board sees several advantages in allowing the industry to take the initiative if it can do so promptly. Because it is difficult to predict the effect of the addition of significant new facilities to the nation's securities market system, it is advisable to allow those most familiar with the system to propose the nature of the facilities or arrangements to be instituted as long as (i) the diverse elements in the industry are in general agreement as to the nature of the facilities which should be adopted, and (ii) it is clear that the facilities will meet the required objectives. In addition, by affording the industry the opportunity to initiate a plan for achieving the objectives of a composite book, some of the problems of financing and administering a government-initiated plan could be avoided. Furthermore, this approach of attempting to stimulate the industry itself to provide the solutions to problems is in keeping with and fosters the general aims of self-regulation, which is the foundation on which the relationship between the government and the securities industry has been built.

D. Characteristics of a Composite Book

Since it is not clear that a suitable alternative to a composite book can be found and agreed upon promptly and since, in the Board's view, a composite book, or

some facility or arrangement which would achieve substantially the same ends, is an important element of a national market system with respect to which action should be taken in the near future, the Board, as noted above, recommends that the Commission pursue its analysis and decision making-process with respect to a composite book while the efforts of the NMA are proceeding. For this reason the Board hereby furnishes its views with respect to various characteristics of a composite book and means of facilitating its development.

1. Entry of Orders

a. Who can do so? Both brokers, for their customers, and dealers, for their own account, should be able to enter limit orders directly into the system and should be able to cancel any order they enter as well as to view the status of all orders entered by them.

In reaching this position (and others reflected below) the Board has had the benefit of discussions with its technical consultants. The consultants noted that today the large retail firms, and some smaller firms through correspondents and service companies, have their customers' limit orders captured in data processing systems and that it would be highly inefficient to have those orders printed out on the floor of an exchange only for a clerk manually to reenter the orders back into a data processing system. The consultants also stated that currently many clerical errors are made in the limit order process and that the ability to directly load, cancel, and receive status reports was likely to reduce significantly the quantity of such errors. The consultants advised that exchanges and computer service firms were likely to make available at reasonable cost to smaller broker-dealer firms facilities which would enable such firms to directly enter, cancel, and receive status reports on their orders in the system.

b. Is entry mandatory? The Board concluded that no broker, unless instructed by a customer, or dealer should be obligated to enter any order into the composite book. In many of the members' minds this conclusion was based on the view that an order entered into the composite book should be entitled to priority in execution in every market center as compared to any other order at the same price not in the composite book, no matter the size of the latter order or when it was left in the market center. The belief was that granting orders in the composite book this priority would encourage use of the composite book while not requiring that it be used for all orders. However, some members saw potentially significant disadvantages to granting orders in the composite book this kind of priority. These potential disadvantages are discussed below in Section 2d. entitled "In what priority are orders to be executed?" [Footnote: If such priority were not to be granted to orders in the composite book, at least some members who were in favor of not requiring entry of orders into the book might then take the opposite view, at least with respect to orders below a certain size.]

The Board gave particular consideration to whether the above conclusions should apply to specialists. On the assumption that orders in the book would be entitled to priority over orders at the same price not so entered, the Board concluded that specialists, if authorized by their customers, should be able to hold limit orders outside of the composite book subject to the priority of orders in the book. This might be a useful service which specialists could provide to broker-dealers who chose not to put their own or their customers' orders into the composite book (so as not to disclose the size of the order or for other reasons) because it would obviate the need for the broker-dealer to have an individual floor broker stand in the crowd to represent the limit order not entered into the composite book. It was also noted that this would provide a form of competition for the composite book system which might help insure that its prices remained reasonable. In addition, it was suggested that it was only fair to give the specialist the same opportunities that floor brokers had to hold limit orders.

In this vein, it was noted that the specialist also should be able to accept "not held" orders if a composite book were implemented. In order for this to be possible, the Act would have to be amended. [Footnote: The last sentence of Section 11(b) prohibits specialists from effecting any transaction except upon a market or limited price order.] Therefore, the Board believes that if a composite book with the characteristics suggested herein is to be established, the Commission and the industry should recommend to Congress an amendment to the Act which would permit specialists to accept "not held" orders.

2. Execution of Orders

a. Who is obligated to see that limit orders in the composite book entitled to participate in a transaction actually do so? Each broker-dealer executing a transaction involving a security included in the composite book would be required to insure that any limit order in the composite book entitled to participate in the transaction was included therein.

b. Who can actually execute an order in the book? The Board delineated four major options -- (1) only specialists, (2) specialists and qualified market makers, (3) any broker-dealer (including specialists and market makers), and (4) a computer that would actually price a market order and execute it against an existing limit order recorded in the system. Each of the first three of these alternatives was favored by at least some Board members; however, a majority favored the second.

Under the second alternative, before a broker-dealer could execute a transaction at a price requiring that a limit order in the composite book be executed, he would have to bring at least that part of the transaction which was required under the rules then in effect to be executed against orders in the book to a market center where there was a specialist or market maker who had the ability (through

the use of a computer terminal) to execute limit orders in the book for the particular security involved.

The principal reason that the majority favored this alternative over the first alternative was that this permitted greater competition. The principal reasons for favoring the second alternative over the third were: (i) its costs seemed reasonable (cost estimates ranged from \$5-20 million with the higher figure including site costs for a new computer and the costs involved in phasing in the system over an eighteen month period following the date on which it was otherwise able to operate); (ii) the effects of instituting such a system seemed more predictable because the execution process would closely parallel the execution process in effect today; and (iii) it was believed that this system would best preserve the existence and values of exchange floors.

However, two questions relating to this alternative remained unanswered. First, what would be the number of market makers in excess of the specialists existing today that the system would be able to accommodate within the estimated cost parameters? According to technical consultants to the Board, the exact extent of such excess is difficult to determine because it depends upon a number of variables which are hard to predict. [Footnote: These variables include, for example, the number of persons who desired to be qualified market makers, the number of securities in which each qualified market maker would make a market, his relative activity in each security, and the distribution of individual market makers by firm, i.e., would most be congregated in a few large firms or would most be distributed across the country with only one or two persons making markets in each location?]

Second, what would be the affirmative and negative obligations of those who would be authorized to execute orders in the composite book (the specialists and the qualified market makers)? With respect to the latter question, Board members favoring this alternative believed that the task of answering this question should be postponed until a decision was made (i) to go forward with the implementation and design of a composite book system, and (ii) with respect to the extent to which restrictions on exchange members making markets off exchange floors are to be relaxed.

Those members who favored the third alternative suggested that such a system would make possible significant cost savings. For example, it would eliminate the need for any brokerage commissions to be paid to specialists or market makers in connection with the execution of limit orders. [Footnote: Brokerage commissions paid to specialists on six major exchanges averaged \$20,878,000 a quarter during the six quarters ended June 30, 1976. Since the unfixing of floor brokerage commissions on May 1, 1976, such commissions of specialists on the New York Stock Exchange (which accounted for 89% of the aforementioned total) declined 17.5% in May and 19.7% in June 1976 from what they would have been had the old rates been in effect. The total amount of floor brokerage

commissions cannot be assumed to be savings to the industry. The amount of possible commissions savings must be compared to the costs of developing and operating the new system.] However, the majority's preference for the second alternative over the third alternative resulted primarily from a concern as to the former's cost and technical feasibility, as well as from the higher degree of uncertainty involved in going further at this time in the use of electronic technology. More specifically, concerns centered on the difficulty in clearly projecting (i) changes in trading patterns, including possible changes in the use of limit orders as opposed to market orders, (ii) the continued viability of exchanges, (iii) the size and complexity of the system resulting from a possible increase in the volume of transactions as a result of widespread use of trading strategies involving the automatic generation and cancellation of orders by computers, (iv) the number of market makers participating in the market, and (v) the effect on the liquidity and depth of the markets. Those who supported the third alternative felt that if a properly designed and supervised pilot or pilots could be developed, they might dispel some of the uncertainties which troubled the majority. [Footnote: The Board has received letters from the Cincinnati Stock Exchange and Institutional Networks Corporation stating that such organizations have in operation or ready for operation systems which might be used as a basis for such pilot projects.] It was felt by at least several members of the majority that any composite book system which was adopted ought to be constructed so that it could be efficiently modified if in the future it was decided that instituting an order matching system (the third alternative) was desirable.

c. Compensation for executing limit orders. Today a limit order is left with a particular specialist who is compensated when he executes that limit order. Under a composite book system, a limit order would be entered directly into a central file and would be executed by any one of several specialists or market makers. Thus, arrangements to compensate those who execute limit orders would have to be different from what they are today because the functions of entry and execution would be separated and the executing specialist or market maker would remain unknown to the broker entering the limit order until after the trade. Although the Board did not reach any firm conclusion with respect to the compensation of specialists and market makers for executing limit orders in a composite book system, it did conclude that if compensation was appropriate for such activity, it appeared that the only feasible way of arranging such compensation was through the establishment of a system-wide, predetermined charge.

Those members of the Board who believed that it was appropriate to compensate specialists or market makers for executing limit orders in the composite book pointed out that such persons were providing a service of value which entitled them to remuneration. In a market for a relatively active security a specialist or market maker would himself, or through an assistant, have to constantly monitor the composite book into which limit orders might constantly be entered and canceled by others and, at the same time, the specialist or market

maker would have to monitor the activities in his market center to insure that no transaction took place in violation of the priorities which had to be accorded orders in the book.

Those members who believed that the value of these services was minimal suggested that if the compensation for executing limit orders was really meant to provide an additional incentive to market making, as opposed to compensation for services performed with respect to limit orders, then such incentive should be based not on the limit orders executed by a specialist or market maker, but on other criteria more closely related to the specialist's or market maker's relative contribution to market making activities in a security.

d. In what priority are orders to be executed? Because of the complex nature of the issues relevant to the rules relating to priority, the Board concluded that it might be advisable for the Commission (or any body administering a composite book system which might have the authority to make rules relating to priority) to delay adopting rules on this subject until the relevant issues could be explored further. It appeared that this could be done without delaying the implementation of a composite book because decisions with respect to the rules relating to priority probably would not affect either the technical design or the costs of constructing a composite book in any significant way. Furthermore, if the suggestion of the Board that one or more pilot projects be instituted is adopted, such pilots might provide an opportunity to explore the ramifications of various priority rules. Subject to this general observation, the Board offers the following comments.

(i) Orders in the book versus orders outside of the book. There was general agreement that any order in the composite book was entitled to protection against an execution at an inferior price occurring anywhere and involving a broker or dealer. Similarly, it was generally agreed that size should not be a relevant factor in determining priority of orders at the same price. Many members believed that, at the same price, an order in the book ought to be entitled to priority over any order not in the book. This would encourage persons to use a composite book and thereby make their buying or selling interest more widely known. As mentioned above, at least some members who favored not mandating that all limit orders be entered into the composite book, and at least some in favor of allowing specialists to hold orders outside of the book, took such position on the assumption that orders in the book at the same price as those not in the book would be entitled to priority over the latter.

Other members pointed out that granting priority to orders in the book at a given price level might have a serious adverse impact on some market makers and specialists because the market maker or specialist may, as a result, only rarely have an opportunity to participate in trading. At least one Board member responded to this concern by noting that where there was an active market with many orders in the book on both sides of the market, perhaps it was not

necessary to encourage market makers to make a market in the security by granting their bids and offers parity with orders in the book.

At least one Board member was of the view that if a market maker had to grant priority to orders in the book, he should be obligated to do so only to public orders and not to those of his professional competitors. In response it was noted that as long as each professional had the opportunity of entering limit orders in the book, it was not fundamentally unfair to require a market maker to accord priority to a competitor's order because it had been placed in the book, and that this in fact would encourage professionals to enter orders in the book and thereby inform the public generally of their buying and selling interest.

(ii) Handling of block crosses. There was general agreement that broker-dealers should not be permitted to arrange a block cross transaction at a price less than any buy order or more than any sell order in the composite book without providing for the execution of such better limit orders at the price at which the cross transaction was to be consummated.

(iii) Priority within the composite book. It was agreed that there should be priority by price and that size should not be a factor in granting priority. Several members felt that there should be strict time priority at a particular price level. Others believed that, at a given price, public orders ought to have priority over those of professionals. In support it was suggested that this would encourage public confidence and use of the system. On the other hand, it was suggested that public confidence and use would be encouraged primarily by the participation of limit orders entered into the system in the displacement of portions of block trades, and that it would be difficult to reach a workable and equitable definition of the word "public". It was also pointed out that time priority without preference for public orders might encourage professionals to enter orders which would be firm until cancelled and generally visible to the public. It was noted that any professional willing to enter his order into the composite book should not be put at a disadvantage to others when doing so.

3. Visibility of Orders in the Composite Book

The contents of the composite book should be made available to vendors who would be free to supply information concerning the contents of the composite book in any format permitted by applicable regulations to anyone willing to pay for the service.

Persons who could execute orders in the composite book and were obligated to represent the book in their market center should be obligated to have facilities which enabled them to see all orders in the composite book relating to the securities with respect to which they have a right and obligation to execute orders.

Although the name of the security, time entered, price of the order, and buy or sell designation might be displayed, the identity of the person entering the order should not be displayed. Nevertheless, such information should be stored in the system in order to facilitate reporting.

Persons who could enter and cancel orders should be able to see the status of the orders which they entered.

The reason the Board is in favor of an “open” book is its belief that if several specialists and market makers have the ability to view the contents of the book with respect to a security, then as a practical matter the book with respect to each security might as well be open to all since competition would probably lead to wider disclosure in any event. This would not necessarily add any cost to the system because the central system could make available a full data stream to several vendors without significantly affecting the system’s cost, and these vendors could then deal with the data stream as demand for the information indicated, providing information on the book’s contents in formats permitted by applicable regulations to persons willing to pay for the service.

Although some commentators have suggested that “an open composite book would be an empty composite book,” it seemed to the Board that this comment was directed primarily to the extent to which institutions might place limit orders of considerable size in the book. The Board felt, however, that an economically significant volume of non- institutional orders would be entered in any case and that there would be incentives for the entry of at least parts of block-size orders, especially if orders in the book had priority over other orders at the same price. It was noted that because brokers could hold limit orders outside of the book, alternate methods of handling large institutional orders would still be available. [Footnote: Even if a decision were made that the entry of limit orders into the composite book was mandatory, an exception could be made for orders over a certain size.]

4. Scope of the System

a. Types of orders to be included. Only simple limited price orders to buy or sell a specified amount of securities which are good for the day or good until cancelled should be included. These constitute the bulk of limit orders, and so limiting the types of orders included would simplify the design and reduce the cost of the system. A majority of the Board members were of the view that only buy orders below the best offer and sell orders above the best bid should be able to be entered, thereby avoiding the entry of matching orders. Thus, persons attempting to enter sell orders at or below the best bid or buy orders at or above the best offer would be notified that their order was being rejected because its price matched or penetrated the price of a limit order already entered on the other side.

b. Securities to be included. Initially only exchange traded common stocks, as distinguished from over-the-counter stocks or other exchange traded or over-the-counter securities, would be included. The Board recognizes that regulations setting minimum standards for the admission and retention of issues in the system will have to be devised prior to the start-up of the system.

5. Implementation and Administration

If it becomes necessary for the Commission to direct the implementation of a composite book, then it should request submission of plans to establish a composite book with characteristics which the Commission should specify in its request. At the same time the Commission should publish for comment a proposed rule creating basic obligations with respect to limit orders, perhaps a variant of the "auction trading rule" described in the Commission's 1973 Policy Statement on the Structure of a Central Market System.

In the request for plans to establish a composite book, the Commission should specify that such plans should include provision for a body which would administer the establishment and operation of the book. The Board is presently preparing a report to the Congress, as required by the Act, which deals with the governance and administration of a national market system. The Board expects that such report will be of assistance to the Commission in its decision-making process on this subject.

MINORITY VIEWS

One member of the Board felt that instituting any type of composite book would so radically restructure the securities markets that trading in listed securities would evolve into a multi-dealer, over-the-counter type of market. He believed that instituting any composite book, therefore, would be the demise of all exchanges and exchange trading and as a result a valuable national asset would disappear by fiat.

That member of the Board was also of the view that, as a result of recent developments in our securities markets, substantial progress has been made towards the establishment of a national market system and that further steps ought not to be taken until the effects of such developments become more clear. The establishment of a consolidated tape, the unfixing of commissions, the lifting of the "New York City rules" which prevented specialists on the American Stock Exchange and the New York Stock Exchange from competing with each other, the New York Stock Exchange's permitting of competing specialists, and the imminent establishment of a composite quotation system were all cited as recent

developments which were likely in the aggregate to substantially achieve the desired ends set forth in the 1975 Amendments to the federal securities laws.

At least two other members of the Board subscribed generally to the view that substantial progress has been made towards the establishment of a national market system; however, they believed that all that was needed in addition in order to achieve the ends prescribed in those Amendments was the repeal of the New York Stock Exchange's rules restricting off-board trading by members.

On the other hand, two members of the Board believed that a computerized system which automatically executed matching limit orders was technically feasible today and would reduce costs to the industry and the public. They noted that if one or more pilot projects were instituted, as suggested by the Board, this fact might be clearly established.

* * *

The foregoing is an effort to summarize the views of the Board on the above-captioned subject. As stated above, the Board believes that the development of facilities which would provide protection of limit orders to the maximum extent practical is an important objective of a national market system. The Board also strongly supports the idea that the industry be allowed the primary role in any effort to achieve this objective, as opposed to its being achieved by action mandated by the Commission.

It is the feeling of the Board that if the newly formed NMA can develop a suitable alternative to a composite book within the next three months, then the Commission should consider it favorably. Since it is not clear that a suitable alternative can be found and agreed upon within such period, the Board recommends that the Commission pursue its analysis and decision-making process with respect to a composite book while the industry efforts are proceeding. To assist the Commission in this effort, pursuant to the statutory responsibilities of the Board and in response to your request, the Board has outlined its views with respect to various characteristics of a composite book and means of facilitating its development. The Board also believes that pilot programs, developed either through private initiative or through industry cooperation, would be quite useful to the Commission in its deliberations with respect to the composite book, and therefore recommends that the Commission actively encourage such initiatives and cooperation.

Respectfully submitted,

NATIONAL MARKET ADVISORY BOARD

BY:

John J. Scanlon,
Chairman