OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

August 24, 1977

MEMORANDUM FOR THE HONORABLE LYLE GRAMLEY
MEMBER, COUNCIL OF ECONOMIC ADVISERS

Subject: SEC's Action on Off-Board Trading Rules (Rule 390)

ISSUE

In June 1977, the Securities and Exchange Commission proposed to direct the removal on January 1, 1978, of rules which presently require exchange members to route customer orders to exchange floors for execution (off-board trading rules). The Commission is currently conducting public hearings on this proposal. Some people fear that the removal of off-board trading rules -- before the development of the necessary communications systems and related, orderly competition among market makers in listed securities -- will fragment the market for listed securities and therefore adversely impact our capital raising mechanism.

BACKGROUND

The Securities Acts Amendments of 1975 (signed into law in June 1975) directed the Securities and Exchange Commission to review any and all rules of exchanges which limit or condition the ability of members to effect transactions off-board (off-board trading rules). The law directed the Commission to report to Congress by September 1975 the results of its review, including the effects on competition of the rules. It further ordered a proceeding to amend whichever off-board trading rules impose burdens on competition which are unnecessary.

In September 1975, the Commission reported to Congress that certain off-board trading rules did impose burdens on competition which were neither necessary nor appropriate in furtherance of the purposes of the Securities Exchange Act of 1934. The Commission, therefore, instituted a proceeding to determine whether to modify or eliminate those off-board trading restrictions.

At the Commission hearings in October 1975, Treasury testified that total elimination of all restrictions on off-board trading, prior to the development of the communications elements of a national market system, could threaten our capital raising mechanism and adversely impact capital formation. While Treasury supported the phasing out of restrictions on off-board agency transactions, it opposed the proposed elimination of restrictions on off-board principal (or market making) transactions. It feared that such action would cause fragmentation of the secondary trading markets.

After the October hearings, the SEC in December 1975 directed the removal of exchange rules which restricted the ability of exchange members to effect agency transactions in listed equity securities off the exchange. However, the SEC decided not to remove or modify two off-board trading restrictions on exchange members -- the restriction on in-house agency crosses and the restriction on off-board principal transactions in listed equity securities. The Commission allowed these restrictions to remain in effect pending further review of the need for further development of the essential mechanisms of a national market system.

In the current release of June 1977, the Commission reviews all of the technological developments toward evolution of a national market system. These include the consolidated tape, the composite quotation syste, the national system for clearance and settlement, and most importantly, the initiatives of the securities industry to link all markets. The Commission concludes that the securities industry has not demonstrated, in working toward the goal of a national market system, a lack of necessity for further regulatory action. Therefore, the Commission has proposed to remove the remaining restrictions on off-board trading in listed securities.

FRAGMENTATION AND THE CAPITAL RAISING MECHANISM

Some people argue that the removal of the restrictions on off-board principal transactions in listed securities would encourage securities firms to execute customers' orders in-house. The result would be a proliferation of independent market centers without the communications systems necessary to link them together in a single national market system. Since order flows would be dispersed among these unlinked independent market centers, the efficiency of the pricing mechanism, (which presently relies on the order flow to one trader -- the specialist) would be impaired. Customers would suffer either poor price executions or higher transactions cost as securities firms sought to utilize new and complex communication facilities to obtain access to the various market centers. Moreover, fragmentation of the markets could disadvantage limit orders since these orders would be bypassed more frequently.

Opponents of the theory of fragmentation believe it is unlikely that many unlinked independent market centers would necessarily arise. First, since market making requires a fair amount of capital, few securities firms could be expected to compete with every specialist in every stock.

Second, because of competitive pressures and fiduciary responsibility, securities firms would not permit a fragmentation of the market. A firm would have to consider whether better price execution is available at either another firm or another trading center. Thus, most firms would be reluctant to internalize their order flow, at least until mechanisms are available for advertising and executing against the best bid or offer in all markets. Since specialists on the NYSE have approximately 85 percent of all order flow, they undoubtedly would maintain a strong competitive advantage and would likely continue to attract this order flow after Rule 390 is removed.

PROPOSED TREASURY POSITION

Recent evidence indicates that the securities industry has neither the will nor the economic incentive to develop the necessary technology for a national market system. Endless attempts by industry groups to reach a concensus on the design of the national market system have been futile. Therefore, movement toward a national market system will not be accomplished until either the securities industry is forced by regulatory mandate or an environment develops which motivates the industry to establish the necessary technology.

Removal of remaining off-board trading rules could create the necessary economic incentive for the development of a national market system by the securities industry. This would avoid the necessity of active government involvement in structuring a national market system, and the disadvantages of imposing a system on private industry by governmental fiat. On the other hand, the elimination of off-board trading rules without other government measures may not encourage increased competition among market makers. In addition, it may not stimulate private development of the essential communication mechanisms required to insure that competition in market making develops in a fair and orderly manner.

The Treasury Department is currently drafting a letter to the Commission setting forth the Department's views on the Commission's proposal to remove off-board trading rules. This letter will be submitted to the Commission by August 31. While Treasury's position is still under active review, the Department has tentatively decided to support the removal of remaining off-board trading rules when a composite quotation system is installed. We also will urge the Commission to monitor closely the extent to which added competition fails to develop, or adverse trading patterns appear. If these occur, Treasury will recommend that the SEC expeditiously establish an electronic national market system that includes automatic execution capability.

A. Gary Klesch