NEW YORK STOCK EXCHANGE
New York, NY

June 21, 1966

The Honorable Manuel F. Cohen
Chairman
Securities and Exchange Commission
500 North Capitol Street, N.W.
Washington, D. C, 20549

Dear Chairman Cohen:

Preliminary to our discussion with the Commission on Thursday we are writing to let you know the views of our Special Committee concerning your letter of May 12, 1966, about Rule 394. Mr. Chapman has already met with your staff to discuss various questions raised by our Committee concerning your letter.

Your letter does not seem to cover some points raised in our letter of March 4, and on some matters differs as discussed below:

1. Your letter did not refer to a requirement contained in our letter that member firms file reports with the Exchange on the day following a trade involving a market maker under the Rule. Your staff informs us that there would be no objection to such a requirement.

2. On page 4, 1st paragraph of your letter there is a negative inference that in trades involving 500 shares or more solicitation of a third market maker might be mandatory. Your staff assures us that this inference was not intended and that the Rule is intended to be permissive only; leaving the decision on an order of any size to solicit a third market maker to the sole discretion of the member firm.

3. In the course of the staff discussions one possible difference did come up which was not apparent from your letter, which states in the last paragraph that,

"The market maker would be required to maintain a significant overall net capital position and/or, capital based on the number of securities in which it makes markets."

It was indicated that there is some feeling in the staff, and possibly at the Commission level, that the capital requirement should be low so that the dealer who only wants to make a market in one or two stocks will be able to qualify.

During our discussions and written exchanges so far, it has been a basic premise that capital requirements would be sizeable -- in fact from the very beginning we were assured that they would be. We are convinced that this is a basic condition in any rule if it is to accomplish the objectives sought because:

a) Market makers are not regulated by the Exchange and are not bound as members by the Constitution and Rules of the Exchange. If member, firms are to be willing to seek out market makers to participate in situations that will usually involve sizeable capital commitments, they must be assured of the market makers financial responsibility to complete the transaction.

b) The objective you have stated is to make the market makers' capital available to help with the execution of orders that cannot readily be completed in the auction market. To achieve this objective, the qualifying market maker should have a substantial amount of capital.

c) As a practical matter, the existence of many qualified market makers will make It impractical for the member firm to take advantage of this rule. For he will run the risk of missing the market on the Floor while he is engaged in checking a multitude of market makers.

We are convinced that a capital rule such as we proposed in March is necessary. That would have required a market, maker to have as much capital as the smallest of the existing major third market makers. Our earlier suggestion called for capital in excess of $2 million. We still feel this to an appropriate requirement and desirably would limit the number of eligible market makers to six or eight.

4. Our letter of March 4, 1966, proposed that participating member organizations be required to go to the Floor and get the permission of a Floor Governor before going to a market maker. As we have tried to make clear, our primary interest is the maintenance of a liquid market in depth to serve investors large and small. While your proposal would permit members in the crowd and the specialist to participate when the cross is made, we do not think this is meaningful unless the order has first gone to the Floor so that the members on the Floor know that stock is available. If this is done, we will not continue to insist that the order remain on the Floor for a specified period of time. When a Floor Governor is asked to approve he can question the member with the order and make certain that the orders on the Floor are taken care of and not bypassed. We also want to discuss with you a problem which might arise from the rules regulating specialist activities, unless specialists are put on a parity with the third market.

5. Your letter suggests a requirement that market makers pay 3 cents a share to the Exchange when they participate under the Rule. Our March 4 proposal

required a payment to the member firm handling the transaction of 30% of the minimum commission. This proposal was based on our view that this class of non-members should not participate at a lesser charge than a member utilizing a correspondent arrangement, when the member takes stock for his own account to help complete a customer's order. This was based on the average change made by clearing firms to their non-clearing correspondents. This amounted to approximately 12 cents a share.

In our effort to resolve the few remaining differences we would be willing to accept a charge of 8 cents a share paid to the member which approximates the minimum charge for Floor brokerage and clearance. Take for example, the situation where a non-clearing firm who uses a two dollar broker has a customer's order to sell 10,000 shares of stock. He is able to find buyers for 3,000 shares, can take 2,500 shares himself and informs a third market maker that he can get 2,500 shares for him. Under your proposal the third market maker would pay 3 cents a share or $75, whereas the member firm would be required to pay 8 cents a share or $400. We believe that the third market maker's payment of 8 cents is an irreducible minimum. It must be remembered that the Exchange member not only has to pay this 8 cents charges but in addition as to pay his share of the cost of maintaining the market place.

6. Your letter does not specifically incorporate our earlier understanding that participation by market makers will be for their own account only.

There is another item we have discussed in general terms, i.e., how it is to be made clear that the Exchange has no responsibility for policing the market makers who might: be considered "members" of this Exchange under the 1934 Act. We would like to know your thinking on this point.

Except for those matters discussed above, we think our Committee is in general agreement with the proposals made in your letter of May 12. We look forward to meeting with you Thursday morning and hope we can resolve these few items then.

Sincerely,

G. Keith Funston

cc:
The Hon. Byron D. Woodside
The Hon. Hugh F. Owens
The Hon. Hamer H. Budge
The Hon. Francis M. Wheat