

U.S. House of Representatives
Committee on Energy and Commerce

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

Washington, DC 20515

May 16, 1991

The Honorable Richard C. Breeden
Chairman
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Chairman Breeden:

Pursuant to Rules X and XI of the House of Representatives and its ongoing oversight responsibilities over securities and exchanges, the Subcommittee on Telecommunications and Finance is examining the impact of computerized proprietary trading systems on the national market system (NMS).

As you know, in enacting the Securities Act Amendments of 1975, Congress called for the Commission to facilitate the establishment of an efficient, competitive, and fair national market system for securities. The 1975 Amendments set forward five broad objectives for the markets to address: economically efficient execution of securities transactions; fair competition among market participants; the widespread availability of quotation and trade information; the practicability of brokers executing investors' orders in the best market; and the opportunity for investors orders to be executed without dealer participation. Congress said that these objectives were to be achieved through "the linking of all markets for qualified securities through communication and data processing facilities."

Recent developments relating to the regulation of computerized proprietary trading systems have raised a number of questions regarding the implications of such systems for the National Market System concept set forward in the 1975 Amendments. Some market participants have argued that proprietary electronic trading systems represent a natural and logical extension of the National Market System, while others have maintained that such systems will lead to the demise of the NMS and a "Balkanization" of the securities markets into separate institutional and retail markets -- with the result that fewer orders will be interacting in the national market to produce the best price.

This debate was brought to the attention of the Subcommittee during its hearings on the Stock Market Reform Act of 1990. For example, during a July 27, 1989 hearing before the

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Subcommittee, Steven R. Wunsch, founder of the Wunsch Auction Systems electronic trading system testified that electronic auctions would "improve the fairness of markets in a manner fully consistent with the national market system called for by Congress in 1975." Mr. Wunsch testified that the Commission's practice of granting registration exemptions and providing no action letters to electronic trading systems that compete with traditional exchanges had advanced the NMS directive, but that "because the no action policy is clearly working to implement NMS, exchanges have recently attacked it in letters to the Commission and in one lawsuit."

As a consequence of these developments, Mr. Wunsch suggested to the Subcommittee that the SEC was "not currently sure whether new applicants should register as exchanges, seek exemption from exchange registration or wait for approval of a new registration category called proprietary trading systems." Mr. Wunsch warned the Subcommittee that "this situation threatens to stall further progress toward NMS by allowing exchanges to block the development of new alternatives to exchanges."

The Subcommittee notes that when Mr. Wunsch subsequently applied with the Commission for an exemption for the Wunsch Auction Systems, Inc. electronic trading system from registration as a national securities exchange, several interested parties immediately questioned with the Commission whether such an action was consistent with the National Market System Concept.

The New York Stock Exchange (NYSE), for example, argued to the Commission that an exemption for the Wunsch System should not be granted because "the Congress of 1975 would not have agreed that exempting from registration an exchange that trades national market system securities, and thereby placing it outside of the national market system, is the proper way to address the fragmentation and competitive issues presented by the WASI [Wunsch Auction Systems, Inc.] application." The NYSE argued further that "when Congress restructured the scheme for regulating exchanges to mandate their creation of a national market system only 15 years ago, it intended no escape hatch for start-up exchanges -- and provided none."

At the same time it has raised these concerns about the Wunsch System, the NYSE has brought before the Commission a proposal to establish its own off-hours trading system. The Subcommittee notes that a number of interested parties have come forward to raise questions regarding the implications which this off-hours electronic trading system might have for the National Market System concept. Several of the regional stock exchanges have argued that the NYSE proposed Crossing Session I would contravene the goals and objectives of the NMS by not affording other markets a fair opportunity to participate.

The SEC's Authorization request indicates that "the Commission is examining a variety of related issues posed by off-hours trading, including the transparency of these markets, possible integration of off-hours trade reporting with real-time reporting for equity transactions effected during the normal trading day, and the need for effective surveillance of these markets." In order to better evaluate the issues which the emergence of proprietary electronic trading systems raise for the National Market System, the Subcommittee would appreciate your assistance and cooperation in providing responses to the following questions:

1. What is the Commission's analysis of the implications of the emergence of computerized trading systems for the National Market System, and the extent to which such systems are consistent or inconsistent with the objective of linking all securities markets through communication and data processing facilities?
2. Concerns have been expressed that the proliferation of off-market trading systems, including Instinet's Crossing Network, Jeffries POSIT system, and the Wunsch Auction System may result in a "Balkanization" of our nation's securities markets that would be inconsistent with the National Market System concept of an integrated nation-wide system of competitively traded securities. Concerns have also been raised that as a result, the goal of maintaining an efficient price-setting mechanism for securities will be undermined. Please provide the Subcommittee with an analysis and evaluation of these concerns. In your response, please indicate whether the Commission believes that electronic trading systems designed to facilitate large institutional trading may pose the potential for balkanizing our nation's securities markets into a two-tiered system -- one for large institutional traders and another for individual investors.
3. Please explain why the Commission has chosen to deal with proprietary trading systems such as the Wunsch system through the issuance of "no action" letters and low volume exemptions instead of developing comprehensive general regulations or proposing new legislation which would be applicable to the operation of all such systems.
4. What is the Commission's analysis of the implications of the proposed NYSE off-hours trading system for the NMS? Is the Commission at all concerned that elements of the proposed system will result in a migration of order flow from the regional exchanges to the primary market, with resulting negative implications for the viability of exchanges other than the primary markets (e.g., through increased costs and risks)?
5. To what extent is the Commission concerned that the emergence of propriety electronic trading systems may result in public customer orders migrating from an auction market which ensures price discovery and an opportunity for price improvement, to a non-auction market where the price is fixed?
6. Some of the regional stock exchanges have expressed a concern that aspects of New York's off-hours trading proposal will give the New York Stock Exchange an anti-competitive advantage over the regional exchanges. Specifically, concerns have been expressed that New York's proposed Crossing Session I will cause "Good til Cancelled" orders to migrate from the regional exchanges onto the "Good til Executed" orders being offered during Crossing Session I -- with the result that public customers will not have the benefit of the price discovery mechanism afforded by an auction market. Is the SEC examining these concerns, and how does the Commission plan to deal with the possibility of a migration taking place that would undercut the National Market System concept and disadvantage the ability of public customers to get the best execution of their orders?

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7. Please provide the Subcommittee with a description of the issues and options the Commission is currently considering in its examination of electronic trading systems, including issues relating to the transparency of these markets, possible integration of off-hours trade reporting with real-time reporting for equity transactions effected during the normal trading day, and the need for effective surveillance of these markets.

Thank you again for your assistance and cooperation in responding to the Subcommittee's request. Should you have any questions about the Subcommittee's request, please have your staff contact Mr. Jeffrey S. Duncan of the Subcommittee staff at 226-2424.

Sincerely,

Edward J. Markey
Chairman