

EDWARD J. MARKEY
7TH DISTRICT, MASSACHUSETTS

ENERGY AND COMMERCE COMMITTEE

RANKING MEMBER
SUBCOMMITTEE ON
TELECOMMUNICATIONS AND
THE INTERNET

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RESOURCES COMMITTEE

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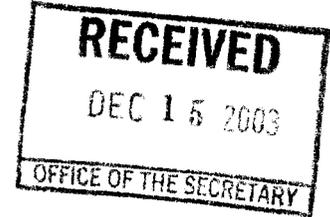
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December 8, 2003

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OFFICE OF THE
CHAIRMAN

The Honorable William Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth St., N.W.
Washington, DC 20549

Re: Boston Option Exchange ("BOX")



Dear Chairman Donaldson:

I am writing with respect to the application filed by the Boston Stock Exchange ("Exchange") for its BOX facility.

You may recall that in 1993 and 1994, I chaired a series of hearings in the Subcommittee on Telecommunications and Finance that examined the progress towards establishment of the national market system envisioned by Congress in the 1975 Amendments to the Securities Exchange Act.¹ You testified at one of these hearings in your former capacity as Chairman of the New York Stock Exchange. During these oversight hearings, the Subcommittee identified a number of areas where reforms by the Commission, the stock exchanges, or other market participants were warranted to further advance the objectives set forth in the 1975 Amendments. Specific reforms identified during the hearings included the need to enhance customer disclosures regarding the practice of dealers offering cash payments and other inducements for customer order flow, improved soft dollar disclosures by institutional money managers, reforms in rules regarding unlisted trading privileges, and curbs on potentially abusive trading practices in the NASDAQ market such as trading ahead of customer limit orders.

At the same time that the Subcommittee was holding these hearings, the SEC staff initiated an examination of many of these same issues, which culminated in its January 1994 report entitled, Market 2000: An Examination of Current Equity Market Developments. Following the issuance of this report, the Commission, the New York Stock Exchange, the NASDAQ and the various exchanges moved to implement many of the recommendations outlined in the SEC report and in the Subcommittee's hearings to enhance market transparency, assure fair treatment of investors, promote fair market competition and open market access. At the same time, the Congress also took legislative

¹-National Market System: Hearings Before the Subcommittee on Telecommunications and Finance, 103rd Congress, First Sess. (1993); Unlisted Trading Privileges, Hearing Before the Subcommittee on Telecommunications and Finance, Second Sess. (1994).

action to address barriers to achievement of national market system objectives -- such as enactment of the Unlisted Trading Privileges Act of 1994 (Public Law 103-389), and the Common Cents Stock Pricing Act of 1997 (H.R. 1053).

Both the reforms implemented by the SEC and the SROs, as well as those proposed or enacted by Congress, have been aimed at assuring that equity market trading practices better serve the needs of investors.

It has recently come to my attention that a number of competing exchanges and their member firms have raised concerns regarding the Boston Stock Exchange's proposal to create an electronic options exchange. Some of these exchanges and firms have raised questions or concerns about the prospect for the proposed BOX system to result in increased internalization of order flow or payment for order flow. As you know from your many years of experience in the securities industry, these are not new issues or concerns.

Back in 1996, I wrote former Chairman Levitt regarding the SEC's decision to grant approval to the Cincinnati Stock Exchange's dealer preference program other broker-dealer arrangements for internalization of customer's order flow. I am attaching a copy of my letter, and the SEC's response, for your review. I would like to call to your attention to the following statement made in Chairman Levitt's letter:

“Because preferencing is so similar to other well-sanctioned market practices, it is not apparent that it should be held to a new, different standard. In theory, if appropriate protections are in place to avoid compromising the customers' interests, and the broker meets its best execution obligations, preferencing should be no more disadvantageous to the customer than the dealer activities of the traditional specialist and should provide similar liquidity and quality of execution.”

The issue, as Chairman Levitt, acknowledged, is whether the rules and protections that are put in place are sufficient to accomplish the goal of investor protection. At that time, the SEC took the position that order handling rules that reaffirmed the duty of best execution and made it reasonably possible for broker-dealers to obtain a better price for a customer were the best way to ensure that inter-market competition was based on price – regardless of the type of market to which the order is ultimately directed for execution. It seems to me that this approach, followed by the Commission with respect to its approval of the Cincinnati Stock Exchange's market structure and order handling rules, as well as Commission review of market structure and trading rules for various other equity markets, should also guide the Commission's approach to the pending Boston Stock Exchange BOX proposal.

- This is particularly the case when, as it appears here, that the Boston Stock Exchange has proposed a system which guarantees opportunities for price improvement

The Honorable William Donaldson
December 8, 2003
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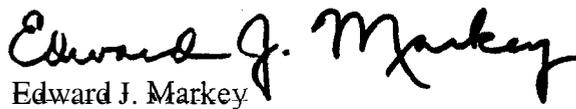
and order exposure. Moreover, it is my understanding that unlike some other competing options exchanges, the BOX system will not sponsor payment for order flow.

I do not agree with the suggestion advanced by some of my colleagues that action on the BOX proposal should be deferred until the publication of yet another SEC white paper on market structure. These issues have been the subject of almost continuous examination by the Commission for nearly a decade, and I am not convinced that we need yet another study before the BOX proposal can be acted upon.

It is my understanding that the Boston Stock Exchange has worked closely with SEC Staff since 2001 to secure approval of the BOX project. During this time period, the Boston Stock Exchange's competitors have made extensive efforts to slow down the approval process while simultaneously filing rules and commencing system changes to attempt to replicate the BOX market model. I would respectfully request that any legitimate concerns and issues be addressed in a timely fashion but that the Commission not place the Boston Stock Exchange's BOX proposal a competitive disadvantage because of the process. I have also been told that over 100 firms have applied to participate and that a recent industry-wide simulation was regarded to be successful and that BOX is ready to begin operation shortly after SEC approval.

Thank you for your attention to this important matter. I urge the Commission to address and approve this application promptly.

Sincerely,



Edward J. Markey
Member of Congress

Enclosures

■

EDWARD J. MARKEY
5TH DISTRICT, MASSACHUSETTS

COMMERCE COMMITTEE
RANKING MEMBER
SUBCOMMITTEE ON
TELECOMMUNICATIONS AND
FINANCE

RESOURCE COMMITTEE
COMMISSION ON SECURITY AND
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June 12 1996

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

Dear Mr. Chairman:

I am writing in regard to the Commission's recent order giving permanent approval to the dealer preferencing program of the Cincinnati Stock Exchange (CSE) and regarding other brokerdealer arrangements for internalization of customers' order flow.

As you may be aware, the Subcommittee on Telecommunications and Finance held a series of oversight hearings in 1993 and 1994 to examine the progress being made towards establishment of the national market system envisioned by Congress in the 1975 Amendments to the Securities Exchange Act.¹ During those oversight hearings, the Subcommittee identified a number of areas where reforms by the Commission, the stock exchanges, or other market participants were warranted to further advance the objectives set forth in the 1975 Amendments. Specific reforms identified during the hearings included the need to enhance customer disclosures regarding the practice of dealers offering cash payments and other inducements for customer order flow, improved soft dollar disclosures by institutional money managers, reforms in rules regarding unlisted trading privileges, and curbs on potentially abusive trading practices in the NASDAQ market such as trading ahead of customer limit orders.

In light of this hearing record, I was generally supportive of many of the principal recommendations made by the Commission staff in its January 1994 report entitled, Market 2000: An Examination of Current Equity Market Developments. Over the last two and a half years, I have been pleased to see the Commission, the NASDAQ and the various exchanges moving to implement many of the recommendations outlined in the report to enhance market transparency, assure fair treatment of investors, promote fair market

¹ National Market System: Hearings Before the Subcommittee on Telecommunications and Finance, 103rd Congress, First Sess. (1993); Unlisted Trading Privileges, Hearing Before the Subcommittee on Telecommunications and Finance, Second Sess. (1994).

The Honorable Arthur Levitt
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competition and open market access. At the same time, I would note that the Subcommittee has taken legislative action, where needed, to address barriers to achievement of national market system objectives -- such as enactment of the Unlisted Trading Privileges Act of 1994 (Public Law 103-389).

Both the reforms implemented by the SEC and the SROs, as well as those enacted by Congress, have been aimed at assuring that equity market trading practices better serve the needs of investors. In light of the substantial progress that has been achieved in this area, I have questions about the Commission's recent decision to issue a permanent approval for CSE's preferencing system. It appears that this system will only further advance trends towards greater dealer internalization of customer order flow, a development which I fear could have potentially adverse implications for investor protection and the health of the national market system.

According to both published reports and the Commission's descriptions of the program, the CSE's preferencing program essentially provides a mechanism for dealer firms doing business on the CSE to take the other side of their own customers' orders. The Commission's order approving the CSE program reports that an SEC staff trading analysis found that "during the period considered, preferencing dealers accounted for more than 90% of trades and two-thirds of share volume on the CSE." In addition, the staff found that "the 281 stocks where preferencing dealers accounted for 80% to 99% of total CSE trades were the most actively traded stocks on the CSE."

While I believe that the competition for orders in NYSE-listed securities offered by the regional exchanges and OTC trading generally benefits investors and should be encouraged, I have serious reservations about CSE's preferencing program and other arrangements for brokerdealer internalization of customers' order flow. Such practices create potential conflicts-of-interest, as brokers might fail to route customer orders to the markets in which the best price might be achieved because of their desire to participate in the trade as principal. As you stated in your recent address before the Economic Club of Chicago:

When buying stocks...you don't haggle with your broker over prices. Unlike the rug dealer, whose quotes reflect only the prices at his store, brokers undertake to provide their customers with the best available market price -- even if they will ultimately be trading from their own inventory. In agreeing to provide its customers with the best execution of their orders, the broker assumes the responsibilities of an agent.

Brokers who trade with their customers out of inventory must make a clear distinction between when they are representing their customer and when they are acting as a dealer. Brokers can act in only one capacity at a time: if they're holding a customer order, they are required to step out of their dealer role and work solely to

represent their customer -- even where **zealous** representation of the customer may **hurt** the firm's **bottom** line, at least in the short run.

I recognize **that** the Commission **has** undertaken certain measures which attempt to **address** the potential conflicts-of-interest **arising from** preferencing or other **internalization** of customer order flow. In order to more fully understand the **evidentiary basis and** policy justifications for **the Commission's** policies in this particular area, I would greatly appreciate your **assistance and cooperation** in providing responses to **the following questions:**

1. The Commission's order approving **the CSE** preference program **states** (on page 27) that "after **analyzing** substantial **data** provided by **the CSE and** commenters, as well as conducting its own **data** collection and **examination**, **the Commission** believes **that the DPP [Dealer Preferencing Program] also has** improved CSE quotations, **and has** added to **the** depth and liquidity of **the** CSE market." Please provide copies of **any analyses, studies**, memoranda, evaluations, or other documents prepared by **the Commission** or its **staff** which **examine** the CSE's preferencing program, its impact **on the** depth and liquidity of its **market**, whether it improves **quotations**, and its impact on member firms best execution obligations.

2. While **the** CSE's preferencing program may have attracted brokerdealers to its market -- thereby improving **that market's** depth and liquidity -- that does not necessarily **mean** it was beneficial to the **operation** of the broader national market system. Are **customers** on the **CSE** receiving the **same opportunity** for price improvement **and** customer order interaction as **they** would on other exchanges that trade **NYSE** listed securities? If so, please provide a comparative analysis which explains what **findings** or conclusions the Commission staff reached.

3. The Commission has recently **noted** that "the **NYSE**, Amex, and other regional exchanges have a lower rate of dealer intervention **than** the CSE" on **an** overall share **basis**,

A) Please provide a table setting forth the rate of dealer intervention on each market which trades listed securities. In **this** chart, please further distinguish between the rate of dealer intervention with respect to small retail orders **and** that for large institutional orders.

B) It **has** been suggested that only small retail orders are executed under CSE's preferencing rules, and that customer limit orders are reportedly rarely put into the **CSE** system where they **might** have a chance to interact directly **with** other customer orders. Based on **the data** provided in your response to the previous question, does the Commission concur? If not, please explain the reasons why.

4. The Commission order approving the **CSE** preferencing program **states** (on page 27) that "the Commission believes that the DPP, as supplemented by the adoption of policies

related to the handling of customer orders, is not **necessarily** inconsistent with best execution of customer orders." To say a trading **system** is "not necessarily inconsistent with best execution" is **hardly** a **ringing** endorsement of preferencing's impact on the public customer.

A) Please explain what specific actions the Commission is **taking** to assure that the objective of best execution of customer orders **will be advanced** (and not compromised) by CSE's preference **system**.

B) I have been **informed** that **the CSE** preferencing rules prevent **any** other dealer interest on **the CSE** **from** trading with a **CSE** member firms' customer order. Do **any** other regional **stock** exchanges which **trade** listed **securities** do **this**? **How** does **the CSE trading system** differ from the competing dealer systems **used** (or proposed to be used) by **some** of the other regional exchanges for **trades** in listed securities?

5. Page 38 of the Commission's CSE order **states** that "**a brokerdealer associated with** a preferencing dealer must **still ensure that** its **order** routing decisions **and** the preferencing dealer's order **handling** practices on the **CSE** (even if in technical compliance with **the CSE's** order **handling** requirements) are consistent with the **firm's best** execution obligations and assess **periodically** the **quality** of competing markets to **assure** that order **flow** is directed to markets **providing** the most advantageous terms **for** its customers' orders."

A) **Has** the Commission **directed** its **staff** or the designated examining authorities for **CSE** preferencing firms to examine such **firms** to **ensure full** compliance with **this** direction? What specific changes have been made in examination modules to assure that such practices are covered during routine or cause inspections or examinations?

B) Are **the** other SRO's whose member firms internalize their order flow conducting **similar** examinations **and inspections** of these member firms to **assure** that **they** are also meeting best execution obligations?

C) If **so**, have such examinations indicated that preferencing/internalizing broker-dealers are in fact meeting their best execution obligations?

D) **Has** the **SEC** **staff's** oversight program specifically reviewed **how** each **SRO** is **meeting** its obligations in this **area** (and if so, what has it concluded about the quality and diligence of **SRO** efforts in **this area**)?

6. The Commission **has** stated, in the **CSE** order and elsewhere, that it is incumbent on the CSE, **as well as** the Commission in its oversight capacity, to ensure **that** best execution is achieved.

■

A) What types of surveillance systems **does** the **CSE** have in place to ensure that dealers **taking** the other side of their customers' orders **actually** are **fulfilling** their fiduciary obligations to achieve the best price for their customers and meet other regulatory requirements? How **many** full-time surveillance personnel are employed by the **CSE**? How does **this** compare to other exchanges (both on **an** absolute **and** a proportional **basis**)?

B) From the initiation of the **CSE** preferencing pilot program to present, **how many** inspections or examinations has the **CSE** performed **which** **specifically** examined member **firm** enforcement brokerdealer best execution obligations **under** applicable **CSE rules and the** federal securities laws? What findings **or** **recommendations** were made in such **examinations** or **inspections**?

C) Within the last year, **has** the Commission staff itself **conducted** any examinations or **inspections** to verify the **adequacy** of **CSE** or brokerdealer surveillance **and** **compliance systems in this area**? Please summarize **the** principal findings **and** recommendations of such examinations. In your response, please **indicate** whether such examinations or inspections **specifically** evaluated oversight of member firms' compliance with their best execution obligations, **and** if **so**, what findings, conclusions, or recommendations were made.

7. On page 38 of the approval order, the Commission **stated** its belief **that** approval of the **CSE** preferencing program is consistent **with** Section 11A of the Exchange Act. -

A) **How** does the Commission reconcile **its** recent **CSE** order, dealer internalization of order flow for 19-c3 stocks traded over-the-counter, or dealer **internalization** by brokerdealers who **route** orders to **an affiliated** specialist, with the specific Congressional **mandate** contained in Section 11A of the Exchange Act which **seeks** to assure **an** opportunity for investors' orders to **be** executed without **the** participation of a dealer?

B) Does the Commission believe **this** part of **Section 11A** is **no** longer **necessary**, or that it should be accorded less weight in Commission rulemakings **than** the other objectives set forth in the Section (such **as** intermarket competition)?

8. How does the Commission reconcile its approval of the **CSE** preferencing program with the general **tenor** of its recent initiatives to promote reforms in the NASDAQ market, including improvements in the **handling** of customer limit orders and improved transparency?

9. During the Subcommittee's oversight hearings in **1993** the General Accounting Office (**GAO**) submitted a report **which** **suggested** adoption of an order **exposure** rule as **a way** to address investor protection issues raised **by** dealer internalization of order **flow**. In the

The Honorable Arthur Levitt
June 12, 1996
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Market 2000 report, the **SEC staff** supported adoption of such a rule, but deferred to the exchanges for action in **this** area following **the** adoption of the other transparency initiatives recommended in the report.

A) While the CSE system does have some **mechanism** for order exposure, it appears to be rather **limited** in **scope**. The Commission's CSE approval order, for example, states that the **policy** applies only "in greater **than minimum variation markets**" and that "a dealer that represents **an** order in its CSE quote does not enter a public agency order into NSTS [**'National Securities Trading System'**]." The Commission CSE order goes on to explain that: "Thus, representing **an** order in **the** dealer's quote would not result in the order being automatically matched with other orders in **NSTS**, such as with paired order trades entered by CSE preferencing dealers." Please provide a **detailed** comparison of **the limited** order exposure available on the CSE preferencing system with the requirements of the order exposure rule **proposed** by the Commission twice in **1982**.

B) **Does** the **Commission** continue to believe that customer orders that are **matched** from a brokerdealers' **own** inventory should **be** advertised to **all** other **markets** to **see** if a superior price were possible for completing the trade?

C) In light of the possibility that Commission approval of the CSE preferencing system will expand the percentage of Rule **390** stocks traded away **from** the **NYSE** or result in other regional exchanges developing **similar** preferencing or internalization systems to compete for order flow in such stocks, shouldn't the Commission **take** the initiative to give adoption of a market-wide order exposure rule a much higher **priority** and press the stock exchanges and **the NASD** for adoption of such **an** order exposure rule **now**?

10. Recent **press** reports suggest that the CSE allowed **trading** in Lucent Technology on the day of Lucent's IPO in violation of **SEC** requirements prescribed pursuant to the Unlisted Trading Privileges Act of **1994 (UTP)** legislation). Such **reports further** indicate that Lucent sales were **being** reported on the CSE at prices considerably higher than those reported on **the primary** market. **W** **e** I recognize that **this** matter is not directly related to the CSE's preferencing program, **as** one of **the** authors of the UTP legislation I **am** deeply concerned about these reports and would appreciate the following information:

A) Please report on how such sales were allowed to occur, how **many** (if **any**) of these sales were **preferenced** trades, how the prices of such trades compared to contemporaneous prices on **the NYSE**.

B) Please explain why the CSE's self-regulatory apparatus apparently failed to prevent trading in Lucent in violation of the UTP legislation **and** applicable **SEC** rules prescribed thereunder.

The Honorable Arthur Levitt
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C) A June 4, 1996 letter you sent to Representative Dingell reports that **the CSE has** "hired **an** independent **firm** to conduct an **investigation** into CSE's procedures and the **trading** in Lucent on April 4. Does the Commission anticipate **that** the CSE will conduct its **own** independent examination **into** these matters, or will it merely rely on the **information** provided by the **outside law firm**? Will you provide a copy of any findings or conclusions reached by **this firm, the CSE, or the Commission staff** upon completion of **this investigation and** please report on **any actions taken** in response by **the CSE, the SEC staff, or the Commission.**

D) I understand **that the SEC staff** commenced **an inspection** of the CSE's UTP approval procedures **and the trading of Lucent on the CSE on April 4.** What were the **results** of this inspection?

Thank you for **your assistance and** cooperation in responding to **this request.** It is requested that a **response** be provided within **15 working days,** or no **later than** July 3, 1996. Should **you** have any **questions** about **this request,** please have your **staff contact** Mr. Jeffrey S. Duncan of my **staff at 225-2836.**

Sincerely,



Edward J. Markey
Ranking Democrat
subcommittee on Telecommuni-
cations and **Finance**



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 3, 1996

The Honorable Edward J. Markey
Ranking Member
Subcommittee on Telecommunications and Commerce
U.S. House of Representatives
2133 Rayburn House Office Building
Washington, D.C. 20615-2107

Dear Congressman Markey,

Thank you for your letter, dated June 12, 1996, regarding the Commission's recent permanent approval of the Cincinnati Stock Exchange's ("CSE") preferencing program and other broker-dealer arrangements for the internalization of customer order flow.

As you know, questions concerning the conflicts of interest inherent whenever a broker deals as principal with its own customer order flow predate the establishment of the Commission. Congress wrestled with these conflicts in drafting the Securities Exchange Act of 1934, and at times has considered whether the dual broker-dealer function poses so much conflict that they should be separated by statute or rule. Over the years, Congress and the Commission have opted for a regulatory scheme that attempts to balance the need for efficiency and liquidity in our markets against the potential harm to investors of principal/agent conflict. Our regulatory scheme also recognizes that competing markets, which may have different structures, provide greater efficiencies, encourage the development of new technology, and promote competition in price and services to investors. Congress has declined to endorse a single market through which all orders must flow, or even a single market structure. Nonetheless, it is incumbent on the Commission, and Congress, to periodically assess how intermediaries deal with order flow, and whether the market structures in place assure that customers' orders receive the fairest possible treatment.

The Commission is presently engaged in this process. Last September, we proposed a series of order handling rules and issued an interpretation reaffirming the duty of best execution. These initiatives were designed to address the conflicts of interest between customers and brokers who trade with them out of inventory. Simply put, where it is reasonably possible for broker-dealers to obtain a better price for a customer, the Commission expects them to do so. By assuring a high standard of order handling, we hope to reaffirm the goal of best execution. The proposed rules aim to

assure that competition is based on price, regardless of the type of market the order is directed to for execution. For these reasons, the proposed rules apply to auction as well as dealer markets.

Preferencing is the latest version of the principal/agency debate. Like the specialist system, the combination of brokerage and money management, and the internalization of listed and OTC securities, preferencing is a manifestation of the tension between the duty of an agent and the need for efficiency and competition in the market. Like a large integrated firm that internalizes Rule 19c-3 securities, a preferencing dealer is attempting to gain economies of scope through efficient use of vertically organized distribution networks; achieve economies of scale with order flow it has generated; avoid sending business to its competitors; and capture the dealer's turn, or spread. Because preferencing is so similar to other well-sanctioned market practices, it is not apparent that it should be held to a new, different standard. In theory, if appropriate protections are in place to avoid compromising the customers' interests, and the broker meets its best execution obligations, preferencing should be no more disadvantageous to the customer than the dealer activities of the traditional specialist and should provide similar liquidity and quality of execution. The question you appropriately ask is whether the protections now in place are sufficient to accomplish this.

The Commission carefully reviewed the CSE preferencing pilot during its five-year duration before granting it permanent approval. This involved consideration of comments submitted by competing markets and broker-dealers. In reviewing the CSE's preferencing pilot, the Commission **also** considered whether it was consistent with economically efficient execution of securities transactions, fair competition among brokers **and** dealers and among exchange markets, the practicability of brokers executing investors' orders in the best market, and the 'practicability of orders' execution without the intervention of a dealer; the standards Congress prescribed in the Exchange Act.

After analyzing substantial data provided by the CSE and commenters, as well as conducting its own data collection and examination, the Commission concluded that preferencing had improved CSE quotations and added to the depth and liquidity of the CSE market. The Commission found that the CSE's preferencing program has increased the CSE's ability to compete with other markets without sacrificing investor protection, and thus furthered the objectives of Section 11A of the Exchange Act. The Commission found no evidence that investors' orders were disadvantaged. The safeguards for customer protection which are in place at the CSE

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appear to be equivalent to or, in some cases, superior to, those of other markets.

Enclosed is a memorandum prepared by the Division of Market Regulation which responds to your specific questions. If you have any additional questions regarding these matters, please do not hesitate to contact me personally, or Richard R. Lindsey, Director of the Division of Market Regulation, at (202) 942-0090.

Sincerely,



Arthur Levitt

Enclosures

MEMORANDUM

TO: Arthur Levitt, Chairman

FROM: Richard R. Lindsey, Director 
Division of Market Regulation

RE: Responses to Questions from Congressman Markey

DATE: July 3, 1996

Division staff have prepared the following responses to questions (in bold) put forth by Congressman Edward J. Markey, Ranking Member of the House Subcommittee on Telecommunications and Finance, concerning the Commission's recent permanent approval of the Cincinnati Stock Exchange's ("CSE") preferencing program and regarding other broker-dealer arrangements for the internalization of customers' order flow.

1. **The Commission's order approving the CSE preferencing program states (on page 27) that "after analyzing substantial data provided by the CSE and commenters, as well as conducting its own data collection and examination, the Commission believes that the DPP [Dealer Preferencing Program] also has improved CSE quotations, and has added to the depth and liquidity of the CSE market."** Please provide copies of any analyses, studies, memoranda, evaluations, or other documents prepared by the Commission or its staff which examine the CSE's preferencing program, its impact on the depth and liquidity of its market, whether it improves quotations, and its impact on member firms' best execution obligations.

The Commission's order permanently approving the CSE's preferencing program specifies the data relied on by the Commission in concluding that preferencing had improved CSE quotations and added depth and liquidity to the CSE market. Among the data relied on by the Commission was the attached analysis of CSE trades and quotes undertaken by the Commission's Office of Economic Analysis, which found that the CSE consolidated quote for stocks in which preferencing dealers accounted for 80% to 99% of total CSE trades matched the NYSE best bid or offer more than 50% of the time, with an average depth of over 720 shares. This compares very favorably to many other stock exchanges and indicates that preferencing dealers maintained competitive quotations that have added liquidity to the national market. Further, the Commission was provided with substantial data from both the CSE and the New York Stock Exchange ("NYSE"), copies of which are attached, on the impact of preferencing on the quality of order execution and market making on the CSE. This data was analyzed closely by Commission staff in connection with the permanent approval of the CSE's preferencing program.

2. While the CSE's preferencing program may have attracted broker-dealers to its market -- thereby improving that market's depth and liquidity -- that does not necessarily mean it was beneficial to the operation of the broader national market system. Are customers on the CSE receiving the same opportunity for price improvement and customer order interaction as they would on other exchanges that trade NYSE-listed securities? If so, please provide a comparative analysis which explains what findings or conclusions the Commission staff reached,

In response to the Commission's request for data from the CSE to show the effects of preferencing on the quality of CSE order execution and market making, the CSE reported that CSE executions in greater than minimum variation markets receive price improvement at a rate that is comparable to that of the NYSE and the regional exchanges. Specifically, in the attached June 14, 1995 letter to the Commission, the CSE provided an analysis of trading on the national securities exchanges and the over-the-counter ("OTC") market, for the period April 27 through May 4, 1995, in 237 CSE-traded issues that had only preferencing dealers. The CSE found that in greater than minimum variation markets, 62% of CSE trades were executed between the ITS best bid or offer ("ITS/BBO"). This percentage exceeded or was equivalent to that of the other regional exchanges and the OTC market, and was not significantly different than that of the NYSE.

Furthermore, for the first quarter of 1995, for CSE stocks with a greater than minimum variation spread, the CSE determined that it provided executions between the ITS/BBO 57% of the time, with an additional 3% of orders receiving price improvement after having been exposed at prices that narrowed the ITS/BBO to a minimum variation. These figures improved slightly for the fourth quarter of 1995, when the CSE determined that the respective numbers were 59% and 4%.

3. The Commission has recently noted that "the NYSE, Amex, and other regional exchanges have a lower rate of dealer intervention than the CSE" on an overall share basis.

- A. Please provide a table setting forth the rate of dealer intervention on each market which trades listed securities. In this chart, please further distinguish between the rate of dealer intervention with respect to small retail orders and that for large institutional orders.

As an initial matter, the Commission has not indicated that the other regional exchanges have a lower rate of dealer intervention than the CSE. Indeed, in a response to an inquiry from 19 Members of Congress about CSE preferencing, the Commission noted that on the regional exchanges, the majority of small retail

orders are executed by a specialist.

A response to the specific question regarding the rate of dealer intervention must begin with an understanding that dealer intervention occurs in many forms on all the exchanges, including the NYSE. Indeed, it is instructive that the amount of dealer intervention on the NYSE on an absolute share basis far surpasses the overall volume in NYSE-listed issues on the CSE. For 1995, NYSE specialists' purchases and sales amounted to approximately 15 billion shares. In contrast, the CSE's overall trading volume in NYSE-listed issues for 1995, including preferencing and non-preferencing dealers, amounted to approximately 1.83 billion shares.

Using the NYSE as an example, there are a number of ways through which a broker-dealer can internalize order flow and for a specialist to trade as a dealer with a customer order. In addition, there are a number of practices on the NYSE floor that result in customer interest being bypassed. These include:

- o Broker-dealers on the NYSE can internalize customer orders by using floor brokers that bring paired broker-dealer and customer orders to the trading crowds. Unless the paired order is broken up under applicable NYSE rules, the broker-dealer will take the other side of its customer's order.
- o Several NYSE member firms with significant retail customer order flow have affiliated specialist units on the NYSE, and route customer orders to their affiliated specialist for execution. This practice is permitted under NYSE rules.
- o NYSE Rule 116.30 permits a specialist to stop market orders under certain circumstances, and execute the order against itself or incoming orders, creating the possibility that contra-side limit orders will be bypassed, even though such orders were resident on the specialist's book prior to the time the specialist granted the stop.
- o NYSE Rule 72(b) (the "clean cross" rule) allows a member who has an order to buy and an order to sell 25,000 shares or more, which are almost exclusively institutional orders, to cross those orders at the prevailing price, irrespective of whether there may have been pre-existing customer bids and offers at that price. Thus, an NYSE member can cross a block on the floor and bypass not only pre-existing professional interest, but also pre-existing customer interest.
- o NYSE's rules of priority, precedence, and parity enable members with the largest sized bid or offer to establish precedence based on size after a trade and thereby "size out" other market interest, particularly smaller retail orders, that may otherwise be on parity with the member's larger

order. Specifically, once a trade occurs on the NYSE, a new auction begins and all bids and offers must be reestablished, including the limit order book. If a new order is announced on the floor that is larger than the limit order book, it will have precedence over the limit order book. This allows a broker-dealer to trade ahead of preexisting retail interest on the limit order book.

Aside from dealer intervention on exchanges, for many years broker-dealers have internalized customer orders in listed stocks that are not subject to exchange "off-board trading" restrictions ("Rule 19c-3 securities") in their upstairs trading facilities. The Commission permitted this trading to foster market competition, despite the resulting dealer participation in these trades.

Moreover, internalization of orders is widespread in the OTC market. Nasdaq market makers usually internalize their customer order flow in the stocks in which they make a market and without the order handling requirements imposed by the CSE on its dealers. Indeed, until 1994, Nasdaq market makers were able to trade for their own account at prices superior to customer limit orders they held internally.

As the foregoing indicates, it is a difficult matter to determine with precision the rates of dealer intervention on the various equity markets. Although specialist participation rates are compiled by the various exchanges, such rates are primarily used by the exchanges to monitor specialist activity. They would not provide a useful measure of the amount of actual dealer intervention because they would not include all the types of situations noted above.

- B. It has been suggested that only small retail orders are executed under CSE's preferencing rules, and that customer limit orders are reportedly rarely put into the CSE system where they might have a chance to interact directly with other customer orders. Based on the data provided in your response to the previous question, does the Commission concur? If not, please explain the reasons why.**

CSE dealers are not required to enter public agency limit orders into the CSE's central limit order book.¹ CSE dealers

¹ The CSE reported that in the first quarter of 1995, 2104 preferenced orders interacted with pre-existing public agency limit orders on the CSE's book. In the fourth quarter of 1995, the CSE reported that 4802 preferenced orders interacted with agency limit orders on the CSE's book. As volume on the CSE grows, there also appears to be a concomitant growth in the number of limit orders placed on the CSE's book.

handle limit orders in a variety of ways. Some send them to other markets for execution, some place them in the CSE limit order book, and some handle the execution themselves. In permanently approving the CSE's preferencing program, the Commission also granted approval to new CSE order handling rules, two of which related to the handling of public agency limit orders. The Commission believes that these limit order policies should promote greater order interaction on the CSE through improved quotations and increased volume on the CSE's central limit order book, as well as add to the quality of information displayed to the national market system.

The first policy, relating to public agency limit order protection, requires CSE dealers to execute limit orders routed to a CSE **dealer** for execution on the CSE in a timely manner relative to executions on the primary market. The second policy is an amendment of an existing policy regarding the display of public agency limit orders. Under this amended policy, a preferencing dealer will be required to display on the CSE all or a representative portion of public limit orders that he or she represents as agent for execution on the CSE priced at or better than the ITS/BBO. A dealer may satisfy this requirement either by representing the orders in their CSE quotes or placing the orders on the CSE's central limit order book.

In the CSE preferencing approval order, the Commission recognized that the holding of customer limit orders that are routed to a CSE dealer for execution on the CSE outside of the CSE's central limit order book raised concerns about whether such order handling practices are consistent with a CSE dealer's best execution obligations. Therefore, the Commission emphasized that a CSE dealer choosing to represent a customer limit order in his or her quote instead of on the CSE's central limit order book must ensure that the customer is not disadvantaged as a result of that decision. In this regard, the Commission further noted that a CSE dealer choosing to represent a limit order in his or her quote has the obligation to monitor executions on the CSE to ensure that the limit order receives an appropriate execution. It also should be noted that the Commission's proposed Order Execution Obligations proposals would require CSE dealers to promptly display limit orders in their quote, execute them, or route the orders to a market that displays them.

4. The Commission order approving the CSE preferencing program states (on page 27) that "the Commission believes that the DPP, as supplemented by the adoption of policies related to the handling of customer orders, is not necessarily inconsistent with best execution of customer orders." To say a trading system is "not necessarily inconsistent with best execution" is hardly a ringing endorsement of preferencing's impact on the public customer.

- A. Please explain what specific actions the Commission is taking to assure that the objective of best execution of customer orders will be advanced (and not compromised) by CSE's preferencing system.

The Commission, in its oversight capacity, will continue to ensure that the self-regulatory organizations ("SROs") will monitor the quality of executions received by customers in all markets. The preferencing approval order emphasized that it is incumbent on not only the Commission, but also the CSE as an SRO, to ensure that CSE members provide best execution for customers. The CSE has developed surveillance modules designed to enforce a broker-dealer's obligations under the CSE Rules and the federal securities laws. With regard to CSE dealers, if a deterioration in the performance of preferencing dealers were evident, in addition to considering possible regulatory action with respect to those dealers, the Commission would consider whether the CSE would need to discontinue the preferencing program, or take other actions to improve the quality of market making on the CSE.

Moreover, apart from the examination of the CSE program, the Commission has renewed its focus on execution quality in all markets in the past year, as is reflected by our recent Order Execution Obligations proposal to improve customer order handling and **transparency in all** markets. In addition, the Commission has renewed its emphasis on a broker-dealer's duty of best execution, as reflected by the issuance of a best execution interpretation in connection with the Order Execution Obligations proposal. This interpretation reiterated broker-dealers' obligation to provide their customer orders with the best prices reasonably available. Likewise, in approving the CSE's preferencing program on a permanent basis, the Commission noted that a broker-dealer choosing where to automatically route orders must assess periodically the quality of competing markets to assure that its order flow is directed to markets providing the most advantageous terms for its customer's orders. Thus, the Commission made clear in the CSE preferencing approval order that a broker-dealer sending orders to the CSE must satisfy itself that this routing decision is consistent with its best execution obligations. In reaching this conclusion, the broker-dealer must rigorously and regularly examine the executions likely to be obtained for customer orders in the markets trading the security, together with any other relevant considerations in routing such orders.

- B. I have been informed that the CSE preferencing rules prevent any other dealer interest on the CSL from trading with a CSE member firm's customer order. Do any other regional stock exchanges which trade listed securities do this? How does the CSE trading system differ from the competing dealer systems used (or proposed to be used) by some of the other regional exchanges for trades in listed securities?

As noted in the answer to Question 3, the CSE is not unique in the ability of a dealer to trade with its customer interest. The CSE, however, is unique among registered national securities exchanges in that it is totally automated and utilizes a competing market maker system.' Prior to the adoption of the preferencing program, the multiple CSE dealers could lose all or a portion of their public orders entered into the CSE's National Securities Trading System ("NSTS") to other market makers on the Exchange. This was not the case with the unitary specialists affiliated with order flow firms on the other exchanges, who did not face the price competition of other specialists on their floor in their assigned stocks. The CSE believed that altering the priority rules between professional trading interests was necessary to put the CSE dealers on par with other specialists internalizing order flow and consequently attract retail order flow and enhance liquidity on the Exchange. Preferencing dealers are given priority over professional agency or principal orders entered prior in time when such dealers are interacting with a public order it represents as agent.

Under the preferencing program, CSE dealers send paired trades, which must be priced at or between the ITS/BBO, to the CSE's system for execution.³ Before executing the paired trade on the CSE, the CSE's system replaces the preferencing dealer's side of the trade with any public agency order at the same price that is on the CSE's central limit order book.⁴ If there are no such public agency orders, the paired trade is executed, regardless of other CSE dealers' quotes at the same price. In this manner, the program provides preferenced orders an opportunity to interact with customer orders on the CSE's central limit order book, while permitting CSE dealers to match against their own customer orders if those orders would have otherwise been executed against another professional. Whenever effecting a retail-sized trade against a preferenced order, the CSE dealer must provide an execution at the

² Securities Exchange Act Release No. 28866 (February 7, 1991), 56 PR.5854 (February 13, 1991) (initial CSE preferencing pilot program approval order).

³ The dealer may interact with public orders it represents as agent either by (1) taking the contra-side of the trade as principal ("paired order trade" or "POT"), or (2) crossing the order with another customer order it represents as agent ("agency cross"). The majority of agency crosses are the result of a limit order resident in the dealer's proprietary system at the ITS/BBO, which is matched with an incoming contra-side market order.

⁴ In the case of an attempted agency cross, the system rejects the agency order that is on the same side of the market as the pre-existing order on the book.

ITS/BBO or better, regardless of the preferencing dealer's quote.

The only other national securities exchange currently utilizing a preferencing program is the Boston Stock Exchange ("BSE"), whose competing specialist initiative was approved by the Commission on a permanent basis on the same day as CSE's preferencing program.⁵ In the BSE's program, orders not directed to a particular specialist are automatically routed to the regular specialist for execution, except that orders from a routing firm affiliated with a competing specialist are designated to that member firm's competing specialist to prevent the firm from routing non-profitable orders to the regular specialist.

As with the CSE's program, BSE competing specialists may execute their designated order flow at the ITS/BBO or better, subject to two limitations that set the BSE's program apart from CSE's. First, under the BSE's program, a specialist quoting at the ITS/BBO would have priority over a specialist that is not quoting at the ITS/BBO. In addition, the earliest specialist bid or offer at the ITS/BBO would have priority. Second, all limit orders sent to BSE competing specialists are entered into the BSE's consolidated limit order book. Under the CSE's program, limit orders routed to a CSE dealer for execution on the CSE must either be entered into the CSE's central limit order book or represented in the dealer's CSE quote when such orders are priced at or between the ITS/BBO.

5. Page 38 of the Commission's CSE order states that "a broker-dealer associated with a preferencing dealer must still ensure that its order routing decisions and the preferencing dealer's order handling practices on the CSE (even if in technical compliance with the CSE's order handling requirements) are consistent with the firm's best execution obligations and assess periodically the quality of competing markets to assure that order flow is directed to markets providing the most advantageous terms for its customers' orders."

A. Has the Commission directed its staff or the designated examining authorities for CSE preferencing firms to examine such firms to ensure full compliance with this direction? What specific changes have been made in examination modules to assure that such practices are covered during routine or cause inspections or examinations?

⁵ The Commission is presently considering a proposal by the PSE to adopt a competing specialist program that would operate in a substantially similar manner to BSE's. See Securities Exchange Act Release No. 36874 (February 22, 1996), 61 FR 8092 (March 1, 1996) (SR-PSE-95-32).

- B. Are the other SROs whose member firms internalize their order flow conducting similar examinations and inspections of these member firms to assure that they are also meeting best execution obligations?
- C. If so, have such examinations indicated that preferencing/internalizing broker-dealers are in fact meeting their best execution obligations?

We cannot provide a written response as to the specifics of Commission or designated examining authorities' ("DEAs") firm examinations or the content of examination modules. We would be happy to provide Congressman Markey's staff with a confidential briefing on these matters.

- D. Has the SEC staff's oversight program specifically reviewed how each SRO is meeting its obligations in this area (and if so, what has it concluded about the quality and diligence of SRO efforts in this area)?

The Commission's SRO oversight program reviews SRO efforts to monitor member firm compliance with best execution obligations in two ways. First, as part of its SRO inspection program, Commission staff reviews the SRO's evaluation of specialist and market maker performance. Such evaluations include a review of order-handling performance. Second, for firm upstairs trading, the Commission staff reviews customer complaints regarding order handling and trade execution and includes these reviews as part of its broker-dealer examination program. We would be happy to provide Congressman Markey's staff with a confidential briefing on these matters.

- 6. The Commission has stated, in the CSE order and elsewhere, that it is incumbent on the CSE, as well as the Commission in its oversight capacity, to ensure that best execution is achieved.
 - A. What types of surveillance systems does the CSE have in place to ensure that dealers taking the other side of their customers' orders actually are fulfilling their fiduciary obligations to achieve the best price for their customers and meet other regulatory requirements? How many full-time surveillance personnel are employed by the CSE? How does this compare to the other exchanges (both on an absolute and a proportional basis)?

In seeking permanent approval of its preferencing program, the CSE committed to creating a preferencing firm examination program and several new exception reports to monitor the quality of preferencing firm customer executions. These reports will look at areas such as primary market print protection, limit order exposure and price improvement. The examination program will supplement the

surveillance reports by conducting an on-site review of various aspects of the member firms' operations, including the member firms' trading desk, preferencing trading policies and compliance procedures.

The CSE currently has a regulatory staff of nine, consisting of three supervisors and six staff. This compares favorably with the other regional exchanges both on an absolute and a proportional basis. Other regional exchanges have regulatory staffs ranging from eight to 11 personnel. The CSE has represented to Commission staff that it will hire at least one more analyst in the near future.

- B. From the initiation of the CSE preferencing pilot program to present, how many inspections or examinations has the CSE performed which specifically examined member firm enforcement [of] broker-dealer best execution obligations under applicable CSE rules and the federal securities laws? What findings or recommendations were made in such examinations or inspections.

During the operation of the preferencing pilot program, the CSE, like other regional exchanges, has conducted surveillance of its exchange market and member trading on its exchange. In June 1996 the CSE added an examination component whereby the CSE will examine each preferencing firm during the next 12 months.

- C. Within the last year, has the Commission staff itself conducted any examinations or inspection to verify the adequacy of CSE or broker-dealer surveillance and compliance systems in this area? Please summarize the principal findings and recommendations of such examinations. In your response, please indicate whether such examinations or inspections specifically evaluated oversight of member firms' compliance with their best execution obligations, and if so, what findings, conclusions, or recommendations were made.

The Office of Compliance Inspections and Examinations conducted an inspection of the CSE's regulatory programs in January 1996. This inspection included a review of the CSE's capacity to monitor member firms' compliance with their best execution obligations. As a result of the inspection, Commission staff received a commitment from the CSE to create a preferencing firm examination program and several new exception reports to monitor the quality of preferencing firm customer executions. The Commission staff believes that effective implementation of the examination program and exception reports will allow the CSE to adequately monitor preferencing firms' compliance with their best execution obligations. As *you* are aware, the findings of the Commission's inspections are confidential. However, Commission staff would be prepared to provide Congressman Markey's staff with

a more detailed confidential briefing on this matter.

7. On page 38 of the approval order, the Commission stated its belief that approval of the CSE preferencing program is consistent with Section 11A of the Exchange Act.
- A. How does the Commission reconcile its recent CSE order, dealer internalization of order flow for 19c-3 stocks traded over the counter, or dealer internalization by broker-dealers who route orders to an affiliated specialist, with the specific Congressional mandate contained in Section 11A of the Exchange Act which seeks to assure an opportunity for investors' orders to be executed without the participation of a dealer?
- B. Does the Commission believe this part of Section 11A is no longer necessary, or that it should be accorded less weight in Commission rulemakings than the other objectives set forth in the Section (such as intermarket competition)?

In Section 11A(a)(2) of the Securities Exchange Act of 1934 ("Act"), Congress directed the Commission to facilitate the establishment of a national market system in accordance with the objectives contained in Section 11A(a)(1) of the Act.⁶ These included:

(i) economically efficient execution of securities transactions; (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets; (iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities; (iv) the practicability of brokers executing investors' orders in the best market; and (v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer. 15 U.S.C. 78k-1(a)(1)(C)(i)-(v) (emphasis added).

Thus, while the opportunity for a customer's order to be executed without the intervention of a dealer is an important objective, it is not granted primacy among those found in Section 11A(a)(1) of the Act. Indeed, it is the only one whose application is specifically subject to the extent that it is consistent with two other objectives. Thus, while this objective is entitled due weight in the Commission's consideration as to whether a particular proposal is consistent with its mandate to facilitate the

⁶ S. Rep. No. 75, 94th Cong., 1st Sess. 8-9 (1975).

establishment of a national market system, this objective is not to be deemed the overriding factor in such considerations.

In approving the CSE's preferencing program on a permanent basis, the Commission carefully considered whether preferencing was consistent with the objectives of Section 11A of the Act both individually and taken together. The Commission believed that preferencing furthered the objectives of Section 11A by promoting competition on the CSE and between markets.' The Commission did note that while preferencing, and the resulting internalization of order flow by broker-dealers, may reduce direct order interaction on the CSE, it does not inhibit dealers from executing orders at or better than the ITS/BBO. Consequently, preferencing does not necessarily reduce the practicability of executing investors' orders in the best market.

Moreover, the Commission believed that the order handling policies adopted by the CSE in connection with preferencing advance a number of the objectives of Section 11A. The Commission noted that the policy requiring that market orders in greater than minimum variation markets be immediately executed at an improved price, or be exposed on the CSE and to other market participants for an opportunity for price improvement, ensures that such orders cannot be internalized by a CSE dealer without first receiving an improved price or the opportunity for price improvement. The CSE order handling requirements go beyond the requirements imposed on broker-dealers trading with their customers in other markets. For example, Nasdaq does not impose price improvement obligations on its dealers. Moreover, the CSE is the only exchange which has a mandatory price improvement policy applicable to all market orders in greater than minimum variation markets.

In addition to the price improvement requirement, the Commission noted that the CSE's limit order handling policies also should promote order interaction on the CSE and add to the quality of information displayed to the national market system. In this regard, these policies should produce spreads that more fully represent buying and selling interest on the CSE and enhance an investor's ability to monitor execution quality.

8. How does the Commission reconcile its approval of the CSE preferencing program with the general tenor of its recent initiatives to promote reforms in the NASDAQ market, including improvements in the handling of customer limit orders and improved transparency?

The Commission granted approval to the CSE's preferencing program and order handling policies as changes to the CSE Rules.

⁷ . The CSE is a fully automated exchange, which offers the possibility of reduced member costs and economic efficiency.

As such, they will have to operate in accordance with any future amendments to the federal securities laws and the rules promulgated thereunder. In this regard, the CSE's order handling policies would be superseded by any final rule adopted by the Commission that imposed greater obligations on market participants. As discussed in detail in the response to Question 9, the Division notes that the CSE's recently adopted order handling policies contain some elements of the proposals set forth in the Commission's recent Order Execution Obligations proposals. It is important to note that these proposals, if adopted, would apply to both exchange and OTC markets, and were intended to address the conflicts that arise when agency orders are internalized in listed as well as OTC markets.

9. During the Subcommittee's oversight hearings in 1993 the General Accounting Office (GAO) submitted a report which suggested adoption of an order exposure rule as a way to address investor protection issues raised by dealer internalization of order flow. In the Market 2000 report, the SEC staff supported adoption of such a rule, but deferred to the exchanges for action in this area following the adoption of the other transparency initiatives recommended in the report.

A, While the CSE system does have some mechanism for order exposure, it appears to be rather limited in scope. The Commission's CSE approval order, for example, states that the policy applies only "in greater than minimum variation markets" and that "a dealer that represents an order in its CSE quote does not enter a public agency order into NSTS." The Commission's CSE order goes on to explain that: "Thus, representing an order in the dealer's quote would not result in the order being automatically matched with other orders in NSTS, such as with paired order trades entered by CSE preferencing dealers." Please provide a detailed comparison of the limited order exposure available on the CSE preferencing system with the requirements of the order exposure rule proposed by the Commission twice in 1982.

In conjunction with the permanent approval of the CSE preferencing pilot, the Commission approved a CSE order handling policy designed to give market orders an opportunity for price improvement. In greater than minimum variation markets, the CSE policy requires a preferencing dealer to either (1) execute a market order at an improved price; or (2) expose that order on the exchange for a minimum of 30 seconds to give other market participants an opportunity to provide an execution at an improved price. A preferencing dealer that chooses the latter alternative first must "stop" the order to guarantee that the customer receives an execution at the ITS/BBO at the time the order was received, in the event that the order does not attract a better price during the

exposure period. Next, the preferencing dealer may choose to (1) expose the order by representing the order in its quote at an improved price; or (2) enter the order on the CSE's central limit order book at an improved price. If the order remains unexecuted after the exposure period, the preferencing dealer may execute the order as principal at the stop price.

The CSE's price improvement policy is intended to ensure that market orders cannot be internalized by a CSE dealer without first receiving an execution at an improved price or the opportunity for price improvement. The CSE procedures provide for exposure of customer market orders not only to other interest on the CSE, but also to the entire national market system through the CSE's consolidated quote. In this vein, the CSE's price improvement policy is similar to a prior Commission initiative regarding order exposure. In 1982, the Commission explored the possibility of adopting its own order exposure rule in light of the concerns over the potential for internalization of order flow. These concerns were based in large part on the Commission's earlier decision to preclude off-board trading restrictions from applying to Rule 19c-3 securities and its order implementing an automated interface between the ITS and the NASD's Computer Assisted Execution System ("CAES").

In May 1982, the Commission proposed two alternative order exposure rules. One rule was based on an NYSE proposal, applicable only to OTC market makers in Rule 19c-3 securities; the other was based on principles developed by the Securities Industry Association ("SIA"), applicable to all market makers in Rule 19c-3 securities. The Commission received over 450 comment letters regarding the May 1982 proposal. While few comments were addressed to the specific elements of the rules themselves, many commenters focused on the threshold issue of whether an order exposure rule was needed. After considering the comment letters regarding its earlier proposal, the Commission proposed a revised order exposure rule in December 1982.

The December 1982 proposed rule was based on augmented proposals submitted by the NYSE and the SIA. The rule would have applied to all broker-dealers trading as principal with their customers in Rule 19c-3 securities. Generally, the rule would have required a broker-dealer to stop a customer order at the proposed execution price and publish a bid or offer on behalf of the order for 30 seconds at a price 1/8 better than the proposed execution price, before executing the customer order as principal. The rule also contained an "order export" alternative that would have allowed a broker-dealer to disseminate the order through CAES without being directed specifically to the broker-dealer's market making desk. The alternative was expanded from the May 1982 proposal to include orders sent to the CSE's NSTS in the belief that this system, linked to ITS, offered similar internal exposure advantages and opportunities for efficient execution of orders in

a competitive environment. As in the May 1982 release, the Commission noted that it had not reached a conclusion as to the ultimate advisability of an order exposure rule and that any such decision would have to be based on a determination whether there would be incremental benefits resulting from such a rule that would outweigh the costs of the additional regulation.

The December release generated over 325 comment letters. The comments largely restated positions put forth at the time of the original release. In August 1983, the Commission decided to defer action on its proposed order exposure rule, based on the limited benefits that would be achieved by such a rule in light of the level of third market trading in Rule 19c-3 securities at that time. The Commission sought comment, however, on the trading experiences of broker-dealers and investors in Rule 19c-3 securities.

- B. Does the Commission continue to believe that customer orders that are matched from a broker-dealer's own inventory should be advertised to all other markets to see if a superior price were possible for completing the trade?**

The Commission has consistently taken the view that healthy competition among diverse market centers can help improve market quality. Nevertheless, the diversity of practices among market centers should be consistent with the opportunity of investors to obtain the best execution possible for their orders. The Commission recognizes that it is of particular importance to ensure that best execution of customer orders is achieved in markets where dealers execute such orders as principal.

In a variety of contexts, the Commission has reiterated that broker-dealers have a **duty** to consider opportunities for price improvement when deciding where to route customer orders for execution.⁸ The Commission has stated that this duty applies to both listed and OTC securities, and exists regardless of whether a broker-dealer internalizes order flow, or whether a particular security is subject to off-board trading restrictions. In this regard, last year the Commission reopened the dialogue regarding the **efficacy** of an order exposure rule. In September 1995, the Commission published for comment its Order Execution Obligations proposal, which included a market-wide price improvement rule. The proposed rule would require an exchange specialist or OTC market maker to provide a customer market order with an opportunity for

⁸ See Securities Exchange Act Release No. 34902 (October 27, 1994), 50 FR 55006 (November 2, 1994) (Payment for Order Flow adopting release); Securities Exchange Act Release No. 36310 (September 29, 1995), 60 FR 52792 (October 10, 1995) (Order Execution Obligations proposing release).

price improvement in greater than minimum **variation** markets. The proposed rule **also** contains a non-exclusive safe harbor that would require market orders to be stopped and exposed at an improved price for 30 seconds. The mechanics of this safe harbor are based, in part, on the Commission's 1982 initiative. As previously noted, the Commission's proposals on Order Execution Obligations would apply to exchange markets, including the CSE.

The Commission received over 150 comment letters on its Order Execution Obligations proposal. The Commission is considering the views of the commenters in determining what final action to take on the proposed price improvement rule.

- C. **In light of the possibility that Commission approval of the CSE preferencing system will expand the percentage of Rule 390 stocks traded away from the NYSE or result in other regional exchanges developing similar preferencing or internalization systems to compete for order flow in such stocks, shouldn't the Commission take the initiative to give adoption of a market-wide order exposure rule a much higher priority and press the etock exchanges and the NASD for adoption of such an order exposure rule now?**

As an initial matter, we note that the Commission's approval of the CSE preferencing program has no **effect on the percentage of Rule 390 stocks traded away from the NYSE. The percentage of Rule 390 stocks among all NYSE stocks will increase over time by the additional listing of Rule 19c-3 securities.** The CSE approval order only provides the CSE with the opportunity to increase the percentage of its trading volume in NYSE stocks.

In the Market 2000 report, the Division specifically recommended that the NYSE and other exchanges consider the development of an order exposure rule. In light of the exchanges' failure to proffer such a proposal (although NYSE supported an order exposure rule in its comment letter to Market 2000), the Commission proposed a price improvement rule in its Order Execution Obligations proposal. **As was** discussed in the response to Question 9.B, the Commission presently is considering what final action to take with regard to its Order Execution Obligations proposal. However, the proposal was predicated on ensuring that customers receive the best execution possible for their orders and to preserve the benefits of a competitive market structure that has greatly enhanced market liquidity, transparency and efficiency, not on whether trading in NYSE stocks occurs in competing marketplaces.

10. **Recent press reports suggest that the CSE allowed trading in Lucent Technology on the day of Lucent's IPO in violation of SEC requirements prescribed pursuant to the Unlisted Trading Privileges Act of 1994 (UTP legislation). Such reports further indicate that Lucent sales were being reported on the CSE at prices considerably higher than those reported on the**

primary market. While I recognize that this matter is not directly related to the CSE's preferencing program, as one of the authors of the UTP legislation I am deeply concerned about these reports and would appreciate the following information:

- A. Please report on how such sales were allowed to occur, how many (if any) of these sales were preferenced trades, how the prices of such trades compared to contemporaneous prices on the NYSE.

Of 785 CSE round-lot trades in Lucent Technologies, Inc. on April 4, 764 were reported "sold." 459 of the trades that were reported "sold" involved trading by the dealer, while 305 were agency crosses, *i.e.*, they were not trades where the dealer executed the order against itself. Virtually all of the trades on the CSE were reported at 31 7/8, the NYSE opening price. The marking of trades as "sold" indicates that the trades were being reported late or out of sequence. It is not unusual for the price of a trade that is marked "sold" to be different from the current market price because the trade is being reported late. A large number of trades reported "sold" at the opening price typically is indicative of a system failure at the opening, or a similar technological problem. This was the case with the CSE Lucent trades, where a systems failure at a single firm appears to have caused queuing and subsequent late reporting of trades executed at the opening.

- B. Please explain why the CSE's self-regulatory apparatus apparently failed to prevent trading in Lucent in violation of the UTP legislation and applicable SEC rules prescribed thereunder.

Section 12(f) (1)(B) of the Act and Rule 12f-2 thereunder provide that a national securities exchange is not permitted to trade a security sold in an initial public offering pursuant to unlisted trading privileges ("UTP") until the second trade day. Pursuant to Section 12(f) (1)(G)(i) of the Act, a security is considered to be the subject of an initial public offering if the offering of the subject security is registered under the Securities Act of 1933 and the issuer of the security, immediately prior to filing the registration statement with respect to the offering, was not subject to the reporting requirements of Sections 13 or 15(d) of the Act. CSE regulatory staff erroneously concluded that because Lucent had filed a shelf registration statement with the Commission in February 1996 for the issuance of up to \$100 million in debt securities, the current offering of stock was not an initial public offering because Lucent had become a reporting company. Therefore, the CSE determined that under the UTP rules it **could** permit trading in Lucent on April 4, the first day of public trading. In light of the CSE's mistake, the Commission staff requested the CSE to conduct a comprehensive review of its procedures for approving new securities for trading UTP on the CSE.

Moreover, the CSE voluntarily agreed to refrain from trading any new securities until appropriate procedures have been implemented.

- C. A June 4, 1996 letter you sent to Representative Dingell reports that the CSE has "hired an independent firm to conduct an investigation into CSE's procedures and the trading in Lucent on April 4. Does the Commission anticipate that the CSE will conduct its *own* independent examination into these matters, or will it merely rely on the information provided by the outside law firm? Will you provide a copy of any findings or conclusions reached by this firm, the CSE, or the Commission staff upon completion of this investigation and please report on any actions taken in response by the CSE, the SEC staff, or the Commission.

The CSE is conducting its own investigation into CSE trading in Lucent on April 4. In addition, it has employed an independent firm to supplement its review. It is premature for the Commission to reach any conclusions on this matter, however, as any disciplinary action taken by the CSE as a result of its investigation could be appealed to the Commission. After the final disposition of these reviews, we would be pleased to provide Congressman Markey's staff with a confidential briefing of the results of both the CSE's investigation and the independent firm's examination.

- D. I understand that the SEC staff commenced an inspection of the CSE's UTP approval procedures and the trading of Lucent on the CSE on April 4. What were the results of this inspection?

The Office of Compliance Inspections and Examinations commenced an inspection of the CSE's UTP approval procedures immediately after the occurrence of events surrounding the trading of Lucent on the CSE on April 4, 1996. While the results of the inspection have not yet been finalized, the CSE has filed new UTP approval procedures with the Commission which, if adhered to, should enable the CSE to prevent the recurrence of a similar event. Commission staff would be prepared to provide Congressman Markey's staff with a confidential briefing on this matter.