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THE NATIONAL MARKET SYSTEM: THOUGHTS ON PAST AND FUTURE DEVELOPMENTS

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The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

The National Market System:
Thoughts on Past and Future Developments

It is indeed a pleasure to be addressing the National Security Traders Association on the occasion of your 52nd Annual Convention. It occurs to me that the National Security Traders Association is only one year older than the Securities and Exchange Commission. It is truly amazing how the formation of a governmental agency charged with overseeing private industry can inspire a sense of necessity and cohesion strong enough to sustain for decades a private organization such as yours. The Commission and NSTA have come a long way together. During that time, our two organizations have dealt with a number of issues, many of which may have equalled but, I'd wager, none of which have surpassed the national market system in importance. That is the subject of my talk today -- The National Market System.

During the past twelve months the Commission has made several important decisions that may significantly affect the structure of our securities markets. I am confident you are familiar with some of the SEC's more important and more recent market structure decisions. The Commission has increased by over 50% the number of OTC securities qualified for trading in the national market system. It has authorized trading of options on OTC stocks, approved a pilot program for side-by-side market making for six OTC stocks, and indicated that it is willing to grant unlisted trading privileges to the exchanges in certain OTC stocks.

Each of these matters has generated intense interest and concern among the various segments of the securities industry, and I know all of you have strong opinions on them. I know because you have not been the least bit shy about sharing those opinions with the Commission, as it should be. Discretion being the better part of valor, I am not about to argue the wisdom of those decisions. That will be tested by time and experience. I would, however, like to address one recurring question raised by you and your colleagues. Time after time, I have been asked: "Where is all this going?" or "Your decisions are taking us down a path, but do you know where it leads?" Today, I would like to assure you that I believe the Commission does realize where these decisions are leading. There is most definitely a philosophical rationale underlying the Commission's recent decisions affecting the structure of the markets.

That philosophy is born of the 1975 amendments to the Securities Exchange Act, in which Congress gave the SEC not only broad discretion but also a mandate to facilitate the creation of a national market system. The 1975 amendments are unique in that they are a legislative mandate for a certain degree of deregulation of our capital markets. In my opinion, two fundamental premises underly the Commission's actions in furtherance of the Congressional mandate. The first is that the various segments of the securities markets should be allowed and should be encouraged to compete with one another. The second is that competitive markets disciplined by suitable deterrent mechanisms,

such as audit trails and surveillance systems, will allow regulators greater flexibility in structuring the securities markets. (I might add parenthetically that I do not believe that audit trails, Chinese walls, surveillance systems and the like are always sufficient protection against potential abuse. However, it is undeniable that these deterrent mechanisms have allowed the SEC to approve novel arrangements for portions of our securities markets.)

The 1975 amendments set forth as their goals: (1) the efficient execution of transactions, (2) fair competition between markets, (3) the availability of quotation and transaction information, (4) the best possible execution of orders, and (5) where consistent with other goals, the execution of orders without the participation of a dealer. Congress also directed the Commission to facilitate the development of a national market system and to "designate the securities or classes of securities qualified for trading in that system." 1/ In connection with designating securities, the legislative history of the 1975 Amendments suggests that Congress believed widespread investor interest should be among the criteria for inclusion in the national market system. 2/ If the Commission's recent decisions affecting the structure of our capital markets are measured against the goals of the Act, one must conclude that those decisions reflect a sensitivity to

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1/ Section 11A(a)(1)(C) of the Securities Exchange Act.

2/ *See, e.g.*, S. Rep. No. 94-75, 94th Cong. 1st Sess. (1975), at 16.

competitive implications and reflect a consistent philosophical rationale.

Before turning our attention to the more recent past, I would like to point out that the foundation for this year's bumper crop of NMS initiatives was established in the early 1980s by requiring the designation of certain actively traded OTC securities as eligible for inclusion in the national market system. 3/ There were two practical results of that decision: first, last sale reporting of trades in those securities, and second, the application of the Commission's "firm quote rule" to those securities. The success of the NASD's NMS program is as well known to you as it is to myself. Among other benefits, the NASD/NMS program has resulted in increased listing competition with the New York and American Stock Exchanges. The NASD and the firms making markets in NMS eligible stocks are to be congratulated for the success in this area.

In November of 1984, the Commission expanded by over 50% the number of OTC securities eligible to become part of the national market system by changing the qualification standards for Tier 2 securities. 4/ The Commission's decision was first and foremost consistent with the 1975 Amendments. The securities that became eligible for the NMS were quality issues with significant widespread interest. The eligibility of those securities

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3/ See Securities Exchange Act Release No. 17549 (February 17, 1981), 46 FR 13982.

4/ Securities Exchange Act Release No. 21583 (December 18, 1984), 50 FR 730.

for the national market system will improve the execution of transactions in those securities and make quotation and transaction information more available, which are two goals Congress explicitly formulated for the national market system. Finally, expanding the number of Tier 2 securities as the Commission did, will ultimately set the stage for multiple trading of those securities, with linkages among all markets. Subsequent to this decision, the Commission issued a release requesting comment on what additional attributes should characterize trading in NMS designated securities such as the need for market linkages, limit order protection, and trade through and short sale rules.

In April of this year, the Commission authorized options trading on OTC stocks -- a major decision in and of itself -- but the Commission also approved a pilot program which would allow side-by-side trading by OTC market makers in six of the most actively traded OTC issues. 5/ Another aspect of that decision was the condition that the exchanges be allowed to participate on an equal basis in the pilot program through unlisted trading privileges in the underlying six stocks.

Virtually every segment of the securities industry found something to like and dislike in this decision. The NASD and many member firms were in favor of side-by-side trading, but protested (1) that a pilot of only six issues was too limited, and (2) that the Commission had "given away" to the exchanges some of the most attractive NMS stocks without a quid

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5/ Securities Exchange Act Release No. 34-26026 (May 8, 1985), 50 FR 20310.

pro quo. Certain exchanges, on the other hand, argued that any side-by-side trading in the over-the-counter market, even a pilot program limited to six issues, was an invitation to fraud and manipulation and would put them at a clear and insurmountable competitive disadvantage. On the other hand, some exchanges welcomed the invitation to apply for UTP's in the six OTC stocks.

I believe that the most significant aspect of the proposed pilot was the authorization of side-by-side trading in the OTC market: the willingness to grant unlisted trading privileges had some competitive implications for the exchanges and the OTC, but clearly multiple markets are not unprecedented. Granting side-by-side market making authority, however, even with respect to only six issues, was a bold new step.

Once again the Commission's decision was first and foremost consistent with the 1975 Amendments. Allowing side-by-side trading in certain OTC stocks, as well as full exchange participation in the pilot program, may enhance competition among the securities markets. The decision also represents a situation in which competitive markets and deterrent mechanisms allowed the Commission to deregulate the market to a limited extent. The Commission authorized the pilot, despite the recognized potential for manipulation inherent in side-by-side trading, in part because of the audit and surveillance trails being developed by the NASD. More important, though, was the structure of the trading market in the six issues, which was so dispersed and competitive among the market makers that we believed the possibilities for manipulation were substantially reduced.

Finally, the Commission's decision was cautious and sensitive to the competitive implications involved. The exchanges were not given the exclusive franchise for trading options on OTC stocks, as they wished, but they were given the wherewithal to compete fairly by getting UTP's in the underlying stocks. I have received many complaints that the Commission's decision on unlisted trading privileges without a complementary order lifting off-board trading restrictions puts the NASD at an unfair competitive disadvantage. With respect ladies and gentlemen, this argument does not persuade me. This is not to say that the Commission does not appreciate the relationship between UTP's and Rule 390, I do certainly. Moreover, the Commission has recently stated in a release that the Rule 390 issue is highly relevant to a final evaluation of how unlisted trading privileges will work. To suggest that the Commission has acted unfairly vis-a-vis the NASD, is to ignore the fact that the Commission began this leveling process not with UTP's but with Rule 19(c)(3), which was one of the first steps the Commission took to break down barriers to competition and to facilitate the creation of a national market system.

Rule 19c-3 prohibits off-board trading restrictions with respect to securities listed on an exchange or delisted from all exchanges after April of 1979. Rule 19c-3 was adopted, in part, to provide experience with the trading of listed securities by competing market makers in an environment free of exchange off-board trading restrictions. Many, indeed probably

many in this room, have questioned whether Rule 19c-3 was a fair or advantageous experiment for the NASD, the reason being that the securities available for off-board trading were not particularly attractive. Whatever force that argument may have had in the early 1980s, it has little today. To take just two examples, British TeleCom and the Baby Bells are "Rule 19c-3 securities", and I have not heard much criticism of the depth, liquidity or attractiveness of the markets for those securities. Ladies and gentlemen, with respect to off-board trading of listed securities, the future is yours to make of it what you will.

One interesting thing about the future is that our concept of what it can and should be frequently changes in accordance with present experience. Therefore, depending on many things, including the outcome of the experiment with UTP's in OTC securities, it may be that the issue of off-board trading restrictions generally, and Rule 390 specifically, will have to be revisited. It may be worthwhile to create a pilot involving some of the most active New York Stock Exchange listings to determine whether off-board trading restrictions should be more broadly curtailed. I think that it is very important to remember that any such liberalizing move or any other type of deregulatory action brings with it additional duties and responsibilities for industry participants.

In my opinion, one feature of the future national market system will be additional duties and responsibilities for firms with respect to retail order flow. Among Congress' goals for the national market system were the best possible execution of orders

and fair competition between markets. Ideally, the level of service customers receive on the OTC market should not differ significantly from that on any stock exchange or vice versa. I am not suggesting that trading in the over-the-counter market will have to be conducted in an auction-type environment identical to that on the New York Stock Exchange, nor am I suggesting that orders must come to any central physical location. What I am saying is that, as you have already recognized, the retail customer must be treated fairly no matter where he trades. Most customers do not come to a securities firm looking for an arms-length transaction with a principal, nor are they invited to come to a securities firm on that basis. Securities firms solicit the trust and confidence of their customers with respect to all securities transactions, not just transactions in exchange-listed stocks. Thus, as we continue to carry out the mandate of the 1975 Amendments by eliminating competitive barriers between the marketplaces, it may be that certain protective measures operating in one marketplace will be transplanted into another. For example, an experiment with lifting Rule 390 might well include an "exposure rule," requiring dealers to expose orders to other dealers for some length of time before execution or to provide some other means to ensure that all markets can compete fairly for order flow. In sum, greater duties in some areas may have to offset greater freedoms in others.

I can assure you that the Commission will be flexible, cautious, and sensitive to the competitive implications of its decisions. Nevertheless, the Commission's mandate is not to

protect any segment of the industry, but on the contrary to promote competition between markets, to attempt to provide for a structure conducive to the best possible execution of orders, and more generally, to facilitate the development of a national market system. The concept of a national market system has come a long way in the last six years, but we are not there yet. Although there have been and will be some bumps and bruises and dislocations along the way, a national market system, I believe, is the reality of the future.

I thank you for your attention.