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RULE 394: STANDING ON THE THRESHOLD

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RULE 394: STANDING ON THE THRESHOLD

An Address By

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I doubt if anyone would dispute me if I suggest that at the moment the most critical problem confronting the SEC and the industry -- even more important than declining profits, low volume on the exchanges, the difficulties of inducing new capital in the industry -- is the fate of Rule 394. Certainly it is a subject upon which no one familiar with the securities industry is neutral and I think it is also fair to say that it is a subject on which few if any such people have mild opinions: universally praise or damnation of the rule is expressed in the strongest and most extravagant language. We are told by the proponents of the rule that if we tinker unduly with it, we will destroy the exchanges of the nation which are so necessary to our capital markets. We are told by those opposed to the rule that if we perpetuate it in any form we will simply compound an injustice that has endured far beyond any justification and deny customers of securities dealers their right to a best execution.

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*The Securities and Exchange Commission, as a matter of policy-disclaims responsibility for any private publication or speech by any of its members or employees. The views expressed here are my own and do not necessarily reflect the views of the Commission or of my fellow Commissioners.

As you know, Congress in the 1975 Amendments to the Securities Acts ordered the Commission to complete within 90 days after enactment of that statute a review of all the rules of all the exchanges "which limit or condition the ability of members to effect transactions in securities otherwise than on such exchanges" and report to Congress the results of such review "including the effects on competition of such rules..." Then, within 90 days after submission of the report to Congress we must conclude a proceeding to amend such anti-competitive rules which do not appear necessary or appropriate in furtherance of the purposes of the Act.

We discerned a number of rules on the exchanges which had the effect of limiting or conditioning the ability of members to execute customers' orders off the exchange and we noted these in our report to Congress. However, as I think was clearly intended by Congress, our principal attention focussed upon Rule 394 and its equivalents on other exchanges, and we left for later consideration the other rules having similar effect. Having delivered our report to Congress on September 2nd -- one of the few occasions upon which the Commission ever delivered a report on time -- we have now scheduled hearings which commence on October 14. These will extend through October 22, with some possibility that witnesses who cannot be accommodated prior to

that time, may be heard thereafter. The time for the submission of written materials expires November 10.

The time frame within which Congress commanded that we act on Rule 394 is a clear indication of the urgency that it attaches to the resolution of this question. You will recall that the House bill and the Senate bill which went to the Conference Committee contained different approaches to the problems of Rule 394. The House bill would have made the retention of Rule 394 in any form extremely difficult; the Senate bill, much like the compromise adopted, was more flexible in the approach and left the ultimate determination of Rule 394's fate to the Commission, a complicated and difficult chore, but an approach which we advocated in the belief that the complexity of the matter lent itself better to an administrative resolution than to a legislative cease and desist. Our espousal of this approach was not born, I can assure you, of any convictions that 394 had to be preserved or that we would ultimately reach a different result than the one which could have followed from the House bill. It originated in the belief that this sort of problem was precisely the sort of problem that the administrative process is designed to deal with, one in which flexibility,, expertise, and statutory assurances of an appropriate hearing

were necessary and desirable. This is not to denigrate or question the outstanding competence which the House Subcommittee developed during the course of its study of the securities industry or the factual base which it developed in the testimony taken by that Subcommittee.

It would appear that the time frame inflicted upon the Commission in dealing with this is inadequate in the face of the complexity and the difficulties of the rule and its consequences. However, we are not coming cold to the subject; it is not a matter about which the staff and the Commission have not thought deeply and carefully. For as long as I have been with the Commission -- which is now over two years -- Rule 394 has been a matter of continuing discussion and concern, hence it is not in 90 days or 180 days, for that matter, that we must gain insight and understanding of the problem.

However, this time schedule does pose certain problems upon us. I for one find it difficult to deal with problems such as Rule 394 without relating them to the development of the national market system. We have within the last month launched the newest effort to come to grips with this problem by the appointment of the Leslie Committee which is under a Congressional mandate to report to Congress by the end of next year concerning the national market system, including a discussion of such

legislation as the development of the system may require. The Yearley Committee which recently completed its work determined that in a central market system there should be a Rule 394 equivalent which would require that all trading in securities that are a part of the system should take place within the system. This conclusion I find somewhat appealing. The very essence of a national or central market system is the reintegration of the markets for securities into a single system; the toleration of market activity outside the system would undermine achievement of that purpose. The concept of the national market system envisages maximum competition among market makers, whether they be specialists on exchanges or in the third market; it contemplates a quotation system which will facilitate best execution; thus, I would think there is some reason for prohibiting trading activity outside the system.

However, this is not to say that Rule 394, as an exchange, rather than a national market system, rule is similarly essential to the operation of markets. The national market system will, as contemplated, embrace within it all those who wish to compete as market makers and will subject them to equivalent rules, it will involve ease of access and a multiplicity of market

centers. However, Rule 394 and similar rules of exchanges operate within an exclusionary context which inhibits to a significant extent the desirability or practicability of participation by exchange members on the floor, membership on some exchanges, market making and exploration of different markets.

I stated that I find it difficult to think of Rule 394 without relating it and the consequences of its repeal to the development of a national market system. I think that if there were no effort afoot to develop a national market system, the approach I would take to Rule 394 would be significantly different. It would be much easier to focus only upon the anticompetitive aspects of it and the extent to which it inhibited best execution, full competition and equal opportunity in markets. However, standing, as I hope we are, on the threshold of the national market system, whose very purpose is to accomplish the purposes that the abolition of Rule 394 would, in the eyes of its critics, accomplish, the problems are somewhat more difficult and complex. It certainly is one of the aspects of the rule that must be considered -- and certainly this is consistent with the standards by which the Commission is to determine the matter - whether the abolition of the rule will enhance or inhibit, promote or deter, the development of

the national market system.

I would hope that during the hearings, those who seek to pursuade us one way or the other would address this problem particularly. If the elimination of Rule 394 will hasten the development of the national market system then I think the rule must be approached in one manner; if on the other hand, its abolition would inhibit that development, then I would suggest we should proceed cautiously. At the moment, speaking only for myself, I can conceive of arguments that would support either position: it can be argued that the elimination of Rule 394 would result in a further fragmentation of markets which would complicate the chore of integrating markets, new and old, into the national market system. On the other hand, it could be well argued that the very fragmentation itself would act as a prod to those in the industry to seek imaginative and speedy solutions to the problems posed by the development of the national market system.

Of course, the legislation specifically recognizes that we are not confined to a simple yes or no on Rule 394. It commands us to "amend" such rules in accordance with the standards set forth there. Thus I would suggest we have a good deal of latitude in fashioning solutions to this problem. It may well be that the Commission would adopt a modification

of the rule that would simply remove some procedural difficulties that attend going off the exchange. It could adopt one of the alternatives set forth in our report to Congress which would provide to exchange members a much enlarged opportunity to execute customer transactions off the exchange when the broker believed that an equal or better execution was available in the third market. One need not be gifted with superior imagination to think of many, many alternatives which could go far in eliminating the disadvantages of Rule 394, without going so far as to endanger the viability of the exchanges as they exist today.

In contemplating this problem, I have often wondered about the extent to which Rule 394 has effectively hindered transactions off the principal exchanges. Certainly there are multiple opportunities, not the least of which is the Cincinnati Stock Exchange, to avoid its impact. However, I would suggest that while those opportunities are undoubtedly availed of with respect to many transactions, the overwhelming bulk of transactions which might be done on the Cincinnati Stock Exchange nonetheless continue to be done on the New York or other exchanges with little or any thought given to the possibilities of an execution off the principal exchange.

Notwithstanding the widespread interest in Rule 394, and the intensity of the debate over it, we have only had 17 requests to testify at the forthcoming hearings. I would suppose this is partly accounted for by the fact that many who otherwise would be disposed to testify will be represented by the various exchanges and others who will appear. I would imagine that we will receive a substantial amount of material in response to our request for written comment.

Of course, speculation is intense these days with regard to the likely outcome of this rather important decision-making process. The Commission's report to Congress was construed by some newspapers and other reporters as an indication that the Commission had already made up its mind and that the hearings were simply window-dressing to comply with the Congressional mandate. Nothing, I can assure you, is further from the truth. While it would, in my estimation, be humanly impossible, for anyone who has been exposed to Rule 394 and the discussions concerning it as closely as the Commissioners have been during their times in office, and in some instances even before then, to be utterly devoid of any opinions with regard to Rule 394, its desirability, its role in the securities markets, nonetheless I think it is most accurate to say that all of the Commissioners are embarking upon this hearing with genuinely open minds and a willingness to listen anew to old contentions and respond attentively to new thoughts. And I think it is equally true

of the staff. I have spoken with a number of those who have worked most intimately with this problem over the years and I find that they are equally responsive to new considerations, are equally concerned with making a decision that is thoughtful, cautious and responsible and are quite willing to recognize the sincerity and strength of arguments on all sides of the issue.

The final resolution to this problem of course is somewhat complicated by the fact that we will at the time of decision be undergoing a changing of the guard, as it were, in the Chairman's office. It is now not expected that Ray Garrett will be in office at the time that decision is made and that his place will have been taken by Rod Hills. It is Rod Hills' intention to attend much of the hearing as a spectator and review during the interregnum the history of the rule and the arguments pro and con that have been made with regard to it over the years and other material that is relevant to the resolution of the problem.

Regardless of the decision the Commission makes, it is certain to be the target for criticism. Congressman Moss has already expressed disappointment that we did not in our September 2nd communication to Congress take a more strongly negative posture with regard to Rule 394. If we permit it to

survive in any form, those who have been the sharpest critics of it will undoubtedly charge us with pusillanimity and catering to the "establishment" of the securities industry. On the other hand, if we abolish the rule outright, there will be charges that we have sounded the death knell for exchange markets in this country, particularly the New York Stock Exchange. One of the reasons that independent regulatory agencies exist is so that they can be immunized to the fullest extent possible from concerns with public opinion and pressures from all directions. We are obviously not insensitive to the concerns that have troubled Congressional leaders; similarly, we are not indifferent or deaf or unconcerned with the forebodings expressed by those who feel that indeed Rule 394 is the linchpin of strong markets in this country.

I cannot predict the outcome of this spirited debate. I can assure you that all of us at the Commission are approaching the problem thoughtfully, carefully, cautiously and with a deep sense of the responsibility we owe to the public in making this somewhat awesome determination.