Remarks Of

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Current Issues in Trading and Markets

Security Traders Association
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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners, or the staff.

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I. Introduction

It is a pleasure to participate in the 59th Annual Convention of the Security Traders Association. Since this is October 18, I should say something about October 19, 1987. I am often asked if there would be a sequel to Black Monday. My answer, of course, is that I do not know. However, with the circuit breakers in place, it appears unlikely that the Dow Jones Industrial Average would ever drop 508 points in one day. The changes in NASDAQ, the increased trading capacity of the New York Stock Exchange, the fact that margins are now subject to the oversight of the Federal Reserve Board, and the improved communication system between regulators and the exchanges should also decrease the likelihood of a one day market crash. A more likely scenario is that a big decline would be experienced over several days. I hope that even that does not occur.

It is my intention today to address four issues that are before the Commission that will have an impact on your profession: passive market making; the proposed short sale rule changes; abuse of the NASD's Small Order Execution System ("SOES"); and the Commission's Market 2000 study. In each of these areas, it is my impression that the Commission is moving forward in a positive constructive manner.

Passive Market Making

As everyone here is aware, Exchange Act Rule 10b-6 prohibits persons engaged in a distribution of securities from bidding for or purchasing, or inducing others to bid for or purchase, any security of the same class and series as those securities, or any right to purchase any such security, until they have completed their participation in the distribution. The purpose of the rule is to prevent participants in a distribution from artificially conditioning the market for the securities to facilitate such a distribution. As a result, distribution participants and their affiliated purchasers,

including market makers, have to refrain from making a market for a certain period of time (either two or nine business days) prior to the commencement of offers or sales of the securities. For a small to medium-sized issuer which may not be heavily traded, this often means that there may not be a market for its shares during this period of time. It has been alleged frequently by NASDAQ/NMS issuers that during this period of time, stock speculators are preying on their shares and are unfairly capitalizing on the absence of a market maker. If these allegations are correct, the situation poses an impediment to the efficiency of the NASDAQ capital formation system, which is an integral part of our national capital formation system.

Last July, the NASD submitted to the Commission an amended rulemaking petition ("NASD Petition") seeking to amend Rule 10b-6 to permit "passive market making" in the distribution of certain NASDAQ National Market System ("NASDAQ/NMS") securities. The NASD argues that the market for NASDAQ/NMS offerings experiences diminished

depth and liquidity when market makers are forced to withdraw from the market in a security because of the operation of Rule 10b-6. The NASD argues further that its Petition will solve the problem posed by the temporary absence of a market maker without opening the door to artificial conditioning of the market for the securities to facilitate a distribution.

According to the NASD, passive market making would allow broker-dealers to continue market making, subject to certain conditions, while participating in a distribution of a security. A passive market maker's transactions would be limited by the activities of others; in other words, the passive market maker would follow but would not lead the market in either size or price.

Under the NASD Petition, passive market making would be allowed only in instances of significant market degradation, which probably will be defined as when market makers representing 40 percent or more of the total reported trading volume would be required to withdraw from making a

market in order to comply with Rule 10b-6. The conditions for passive market making will probably hinge upon: (1) the level and size of quotations and volume of purchases, (2) the qualifications of the market makers, and (3) the surveillance procedures to be implemented by the NASD to monitor this activity.

The passive market making proposal, as contained in the NASD Petition, could have a positive impact on offerings by small to medium sized issuers by allowing for greater depth and liquidity in a pre-existing NASDAQ market for their securities in the period prior to an offering. The NASD Petition appears to be an attractive proposal purporting to improve the efficiency of our capital formation system, and it is expected that this Petition will be considered by the Commission at the open meeting scheduled for this Wednesday.

I anticipate that the Commission, at this meeting, will propose new provisions in the 10b-6 area permitting market makers to engage in transactions in certain NASDAQ/NMS

securities that are the subject of a distribution on a "passive" basis during the two business day cooling off period. The rules probably will be proposed as temporary, with the intention of being reexamined by the Commission approximately two years after being adopted.

If approved, the passive market making proposal would represent a significant development in the Commission's balancing of the need to protect the markets from manipulation during a distribution with the benefits for market liquidity that may result from the ability of distribution participants to maintain relatively normal market making functions. With the proposed parameters of the passive market making activity, coupled with the real-time reporting of transactions and the surveillance plan proposed by the NASD, it appears to me that any activity which presents manipulative concerns could be identified and addressed swiftly.

In addition, it is my understanding that the Division of Market Regulation (the "Division") is examining the effect of

Rule 10b-6 on exchange specialist units affiliated with an underwriter participating in the offering of a security for which the unit serves as specialist. Specialist units affiliated with distribution participants are currently prohibited from bidding for, or purchasing, the security for a period of time during the distribution. The Division has apparently consulted and is continuing to consult with the securities industry as to whether less severe trading restrictions on trading activities may be appropriate.

It will be interesting to observe the developments resulting from these consultations. I understand that New York Stock Exchange specialists affiliated with dealers managing markets or exchange offers may now continue market-making activities through part of the offering period if the transactions meet certain stringent specified criteria. According to a recent no-action letter issued by the Division, New York Stock Exchange specialists were granted an exemption from the restrictions of Rule 10b-6, provided that certain issuer qualification and transaction qualification

conditions were satisfied.[1] This no-action letter may be a forerunner of forthcoming broader, more general exemptive relief for exchange specialists from the Rule 10b-6 restrictions.

Short Sales

Now, moving on to a subject that is likely to be nearer and dearer to your heart, I would like to address the proposals concerning the short sale rule. There have been three different Commission releases issued this past summer concerning short sales.

First, in June, the Commission proposed amendments to Exchange Act Rule 10a-1, which is known as the short sale or "uptick" rule.[2] Rule 10a-1 covers short sales of securities listed on a national securities exchange and prohibits short sales at prices below the last reported sale (minus tick) or at the last sale price if that price is below the last different price

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1 Letter from William H. Heyman, Director, Division of Market Regulation, U.S. Securities & Exchange Commission, to Robert McSweeney, Esquire, Senior Vice President, Market Surveillance, New York Stock Exchange, Inc., dated September 15, 1992.

2 Securities Exchange Act Release 34-30772.

(zero-minus tick). The amendments would: (1) provide an exception for a short sale that equalizes the opening price of a foreign security on a U.S. exchange with its price on the principal foreign market for the security; (2) exclude, from the rule, transactions in corporate bonds effected on an exchange; and (3) codify with modifications a staff no-action position relating to certain liquidations of index arbitrage positions.

The Commission also proposed an amendment to Exchange Act Rule 3b-3, which defines short sales. The proposed definition would clarify that if the ownership of a security is claimed by virtue of having entered into a contract to purchase it, the contract must involve a fixed, currently ascertainable amount of the security at a fixed, currently ascertainable price. This proposed amendment is designed to address potentially abusive practices that have developed in the context of certain trading activities and certain dividend reinvestment plans.

The commenters generally supported the adoption of the Rule 10a-1 amendments as proposed, although several changes were suggested. With regard to the international equalization exception, the commenters recommended that the exception not be limited to exchange specialists and market makers, but rather should be modified to include all market participants, and that pre-approval by an exchange official prior to utilizing this exception was unnecessary. The commenters were divided on whether the last reported price on the principal foreign market should also be the reference price when it is above the most recent closing price in the United States and on whether the exception should include alternative foreign markets when the principal foreign market is closed.

The commenters apparently supported the adoption of the corporate bond exception but recommended that it be expanded to include listed convertible bonds. These commenters believed that short sales of listed convertible bonds are not susceptible to the type of market manipulation

that the short sale rule is designed to prevent. I am inclined to agree with this point.

With regard to the liquidation of certain index arbitrage positions, the commenters addressing this proposal supported, either expressly or by implication, the basic policy underlying the proposal. Each of these commenters, however, opposed the duration of the proposed restrictions, and it was suggested that this codification should not impose index arbitrage restrictions beyond the termination of existing New York Stock Exchange restrictions.

The commenters were divided regarding the amendments to Rule 3b-3, and several opposed the proposed price provision. These commenters believed that such a provision would place an undue burden on market participants who enter contracts to buy and sell securities at a price to be determined in the future. As of yet, no timetable for further Commission action on any of these proposals has been announced.

Secondly, I am certain that everyone here is well aware of the Commission's publication of the NASD rule proposal that would prohibit short sales at or below the current inside (best) bid when that bid is lower than the previous inside bid.[3] The proposed rule is analogous to the Commission's short sale rule for listed securities on national securities exchanges but has an exemption for certain market makers. The comment period on this proposal ended on October 2. As of the end of last week, it was my understanding that the Commission had received over 280 comment letters, including one from the STA. Thus, I believe it fair to say that interest in this proposal has been unusually high.

Ostensibly the purpose of the proposal is to produce more comparable short sale regulation between the listed and NASDAQ/NMS markets. The proposal apparently originated from concerned issuers who feared that the lack of a short sale prohibition in the NASDAQ/NMS market has encouraged "bear raids" on their companies. This, in turn, apparently

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[3] Securities Exchange Act Release 34-31003 (August 6, 1992) [57 FR 36421].

caused the NASD to submit their proposal as a competitive response out of concern that these issuers would abandon the NASDAQ/NMS marketplace for the New York Stock Exchange marketplace which, because of Rule 10a-1, already has in place a short sale rule.

The NASD proposal would create a "bid" test for NASDAQ/NMS securities that would prohibit short sales at or below the current inside bid as shown on the NASDAQ screen when that bid is lower than the previous inside bid. The proposed rule includes certain exemptions, including an exemption for qualified market makers that comply with criteria establishing them as primary market makers in the NASDAQ system. The primary criteria for the exemption include the amount of time at the inside bid or offer, comparison of a market maker's spread to the average dealer spread in each stock, and frequency of dealer quotation updates without a corresponding execution in the security.

It is my understanding that Division staff has met with several options specialists to discuss the impact of the NASD

rule proposal on their ability to make off-setting transactions in the underlying securities. The options specialists indicated that they will be submitting further commentary on the proposal, perhaps with some suggestions for an alternative to the NASD proposal.

Written comments received by the Commission thus far on the NASD short sale proposal have ranged from Bear Stearns' dire predictions that the proposed rule created the risk of forcing small market makers out of business to that of the Philadelphia Stock Exchange which supports a short sale rule for over-the-counter trading but criticized the proposed "qualified market maker" exemption on the ground that it would exempt virtually all NASD market makers. The Philadelphia Stock Exchange additionally favored a "tick" test as opposed to the proposed "bid" test.

While I am inclined to favor a short sale rule for over-the-counter trading, I am troubled by at least one aspect of the NASD proposal. This aspect is the multiplicity of "market maker" definitions. There appears to be one NASD

general definition, another definition for purposes of the short sale proposal, and to some extent even another in conjunction with the passive market making rule proposal. In my opinion, it would be preferable to harmonize the definitions. Consistency would be nice, and it would lighten the administrative burden for both regulators and the securities industry. As for the timing of Commission action on the NASD proposal, given the controversial nature of this proposal, I would expect the Commission to act prudently and move cautiously. I am well aware that the STA does not welcome a short sale rule on the NASDAQ/NMS market. It should be kept in mind that what is involved is an NASD rule proposal and not a Commission rule proposal. The Commission's flexibility to deny the adoption of an NASD rule proposal is much less than with respect to its own rule proposals.

One beneficial sidenote to a possible adoption of an NASD short sale rule is that it may lessen the need that

some individuals perceive now exists for a short position reporting requirement. This brings me to the third short sale proposal.

Also last June, the Commission published a release soliciting comment on the concept that material short security positions should be reported publicly. [4] The release was issued in response to a rulemaking petition submitted by the Association of Publicly Traded Companies. The release asked whether a reporting requirement would have an adverse effect on legitimate short selling and whether it was necessary at this time in view of several recent regulatory measures to address specific short sale abuses. In general, the concept of a reporting requirement was favored by issuers and individual commenters and was opposed by broker-dealers and bar associations. My present inclination is that such a rule is unnecessary at this time.

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4 Securities Exchange Act Release 34-29278.

SOES Abuse

Let me move on to address briefly the issue of SOES abuse. As a result of complaints from its market-makers about being "picked-off" by certain order-entry firms, the NASD submitted four proposed rule changes to the Commission in an attempt to remedy this problem. The four proposals: (1) amended the definition of "professional trading account", (2) expanded the definition of "day trade", (3) created a 15 second update period during which market-makers could update their quotations before being required to execute another transaction; and (4) allowed market-makers to indicate from which order-entry firms preferenced orders would be accepted.

The Commission approved the four NASD proposals in October of last year.[5] It did not take long for the customers of two order-entry firms, All-Tech Investment Group, Inc. and Datek Securities Corp., to bring suit against the Commission

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5 Securities Exchange Act Release Nos. 29809 and 29810.

to overturn the approval of the new SOES rules.[6] All briefs have been submitted and oral argument I understand is scheduled for November 13.

The Commission continues to follow the SOES abuse issue carefully. Some in the industry appear to favor pulling the plug on SOES. I do not at the present favor such an approach. I firmly believe that there are several alternatives available to be explored that could further curtail SOES abuse while at the same time preserving SOES. It strikes me that the advent of SOES has been a positive development for the small investor and should be retained if possible.

Market 2000

Apart from proposals relating to trading rules, the Commission is also engaged in a comprehensive study of the equity markets, dubbed "Market 2000," which is the first such study in 20 years. Since that time, the U.S. equity markets have undergone dramatic changes, not the least of which are growth in trading volume, the rise of NASDAQ,

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6 U.S. Court of Appeals for the D.C. Circuit Docket Nos. 91-1502 and 91-1650.

the dramatic increase in institutional trading, the proliferation of derivative securities, and the advances in trading technology.

The regulatory structure for existing markets and alternative systems has reacted to these changes in part as a series of case-by-case responses. Rather than continue a "crazy quilt" approach to regulatory problems, the time is ripe for a new examination of the roles of the Commission and self regulatory organizations in improving the fairness, efficiency, and competitiveness of our equity markets.

The Division intends to conduct a year long study of issues such as market fragmentation, fair competition between markets, payment for order flow, market transparency, and proprietary trading systems. One focus of the study will be on the equitable allocation of regulatory costs.

The study began as a concept release that was published for comment in July. The comment period ends October 20th. Some have inquired if the comment period

will be extended, and the official answer to date is no. However, the staff will not ignore comment letters received after the deadline, so it is better to be late than never. I understand that the Division has informally extended the comment period for one month for multi-member organizations. On the other hand, the earlier the comment letter is received by the Division, the more consideration it is in the position to receive.

I would suggest sending in more than one comment letter as opposed to delaying sending a comment letter until all the relevant issues have been addressed. Some issues require more time than others, particularly when a multi-member organization, such as STA, is struggling to reach a consensus on all the relevant issues. I do strongly encourage comment as this study will have a major impact on the future direction of the regulation of our equity markets.