



INVESTMENT COMPANY INSTITUTE

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SECURITIES AND FINANCIAL REGULATION

January 16, 1996

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: *Order Execution Obligations – Proposed Rules (File No. S7-30-95);
Proposed Rule Change by the National Association of Securities Dealers, Inc.
Relating to NAqcess System and Accompanying Rules of Fair Practice
(File No. SR-NASD-95-42)*

Dear Mr. Katz:

The Investment Company Institute¹ appreciates the opportunity to comment on the Commission's proposed rules concerning the handling and execution by broker-dealers and other market participants of customer orders,² as well as the recent proposal by the National Association of Securities Dealers, Inc. ("NASD") for a computer-based limit order and price improvement facility, called "NAqcess."³

I. Introduction and Summary of the Institute's Recommendations

Mutual funds and other registered investment companies are significant holders of equity securities and are active participants in the equity markets.⁴ As major investors in the equity markets, investment companies often are characterized as institutional investors. Yet investment companies also represent millions of individual investors and, more particularly, allow retail investors to benefit from the economies of scale that appropriately accrue to large volume traders as a result of the normal workings of the market. In addition, many registered investment advisers provide services directly to individual investors, including, among other things, portfolio management services that involve the purchase and sale of equity securities on behalf of client accounts.

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 5,807 open-end investment companies ("mutual funds"), 451 closed-end investment companies and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about \$2.660 trillion, accounting for approximately 95% of total industry assets, and have over 38 million individual shareholders.

² Release No. 34-36310 (Sept. 29, 1995), 60 FR 52792 (Oct. 10, 1995) [hereinafter *Proposed Order Execution Rules*].

³ Release No. 34-36548 (Dec. 1, 1995), 60 FR 63092 (Dec. 8, 1995) [hereinafter *NAqcess Proposal*].

⁴ As of October 1995, total assets of equity mutual funds stood at \$1,189.8 billion. *Investment Company Institute Board Bulletin*, Vol. 1 (Nov./Dec. 1995).

The nature of the equity markets thus has a significant effect upon the ability of the Institute's members to serve their shareholders and customers. In fact, all participants benefit from markets that are liquid and transparent, and that efficiently provide for price discovery. To that extent, markets provide a "public good." Indeed, this is implicit in the 1975 Amendments to the Securities Exchange Act, which set forth Congress' finding that "The securities markets are an important national asset which must be preserved and strengthened."⁵ Consequently, it is important that the regulatory structure that governs those markets encourages, rather than impedes, liquidity, transparency and price discovery.

Thus, for example, the regulatory structure should, to the extent possible, encourage the dissemination of information that is relevant to setting prices. Participants that provide such information (*e.g.*, by entering priced or limit orders) should be rewarded (*e.g.*, by providing appropriate protection and according appropriate priority for such orders). On the other hand, the regulatory structure should not encourage participants simply to "free ride" (*e.g.*, by reducing risks for those who submit orders that do not provide any price information at the expense of those that do).

Moreover, the Commission must be cognizant of the significant developments in technology and market structure that have occurred in recent years. The emergence of new order-based networks has been a positive development for the investing public and is fully consistent with the inter-market competition envisioned by Congress in 1975. Undoubtedly, the growth of such "markets" has caused new issues to arise (such as how to avoid "fragmentation" and how to ensure that price-relevant information from these markets can be communicated to the investing public). In resolving these issues, however, the Commission needs to avoid unwittingly taking steps that will reduce competition and, consequently, market efficiency.

The Institute's comments on the specific elements of the Commission's proposals are based upon the above principles. In general, we support the objective of the proposals, which is to improve the transparency of the securities markets and the handling and execution of customer orders. Nevertheless, while we strongly support certain of the proposed changes, we believe that others may in fact be inconsistent with this objective.

In particular, the Institute opposes the proposed amendment to the Quote Rule that would require exchange specialists and over-the-counter ("OTC") market makers who submit priced orders to electronic communications networks to include those orders in their published quotes. The proposal is unlikely to achieve the Commission's objective of providing better prices to retail customers, as it would likely discourage the use of electronic networks. This, in turn, would result in the widening of spreads for securities traded on such networks and threaten liquidity for market participants. As an alternative, we recommend that the Commission consider expanding the scope of the Intermarket Trading System to include orders entered into such networks.

⁵ Securities Exchange Act of 1934, Section 11A(a)(1)(a).

The Institute strongly supports the Commission's and NASD's proposed rules concerning the display and execution of limit orders, but believes that they do not go far enough. Specifically, we recommend that the proposals be broadened by removing the *per se* exceptions for orders that are over a certain size and dollar amount. At the same time, the Institute opposes the proposed rule regarding price improvement for customer market orders, as it would undermine the goals of the proposed rule changes concerning the display and execution of limit orders.

Each of these matters is discussed in greater detail below.

II. Proposed Amendments to the Quote Rule

The Commission's proposed amendments to the Quote Rule⁶ would, among other things, require exchange specialists and OTC market makers to reflect in their public quotes the bid and offer prices (*i.e.*, priced orders) they disseminate through electronic communications networks that provide the ability to execute against these priced orders. According to the Commission's release, the proposed amendment is "designed specifically to address what the Commission believes to be the potential for market makers to quote one price to public investors but to publish firm quotes in private systems at better prices."⁷

The Institute generally supports the Commission's goals of deterring fragmented markets and improving quotations. We do not support the proposed amendment, however, because we believe it would result in the widening of spreads for securities traded on electronic networks and threaten liquidity for participants who subscribe to these networks.

Mutual funds frequently use electronic communications networks to trade securities on an anonymous basis. For example, securities can be traded anonymously by using the Instinet Trading Service,⁸ which allows subscribers anonymously to submit a firm order designating a security, price and size into the Instinet System.⁹ Anonymity in placing orders provides

⁶ Securities Exchange Act Rule 11Ac1-1.

⁷ *Proposed Order Execution Rules*, at pp. 21-22.

⁸ The Commission seeks comment, among other things, on the types of electronic communications networks that would be subject to the rule. The Institute assumes that, at a minimum, a proprietary trading system such as Instinet, which involves a system that "gather[s] and disseminates, on an anonymous basis, priced limit orders and indications of interest, among system participants, through an automated, screen-based network", would be covered by the rule. See *Market 2000: An Examination of Current Equity Market Developments*, Division of Market Regulation, Securities and Exchange Commission (Jan. 1994), at p. AIV-2-7 [hereinafter *Market 2000 Report*]; *Proposed Order Execution Rules*, at p. 25.

⁹ See Instinet Corporation (pub. avail. Sept. 8, 1986).

mutual funds with significant benefits, including the ability to (1) obtain execution of orders at narrower spreads than might otherwise be obtained if the identity of the fund were known to the person on the other side of the trade,¹⁰ and (2) minimize or avoid adversely affecting market liquidity.¹¹

Market makers that use electronic communications networks such as Instinet also benefit from the network's anonymity features.¹² It allows them a discrete method of determining expressions of interest for particular securities and of covering short and long positions. A requirement that market makers incorporate priced orders into the public bid and ask prices would likely result in market makers substantially reducing or even giving up participation in electronic networks.¹³ As such, fewer market makers may be willing to participate in electronic networks such as Instinet.¹⁴ With fewer participants,¹⁵ spreads will become wider and liquidity may be diminished. This would be particularly harmful for institutional investors such as mutual funds that also rely on such networks to execute trades on an anonymous basis.¹⁶

¹⁰ For example, if the identity of a fund, which had decided to sell a large block of securities of one company or of a number of companies within one sector, were known to the market, purchasers of the securities might attempt to second guess the fund's trading strategy and to adjust their priced orders for the securities being sold. This might effect the fund's ability to obtain the best price when selling the securities.

¹¹ For example, if the identity of a fund, which was an active purchaser or seller of certain securities, were known to the market, market participants might adjust their trading strategies to mirror or follow the trading of the fund, thereby affecting the fund's ability complete its transactions, by reducing the number of willing sellers or purchasers, respectively.

¹² The proposed rule amendment "would not require the OTC market maker or specialist to publish in its publicly disseminated quote the full size of the priced order included in the electronic communications network. Rather, the OTC market maker or specialist would be required to disseminate publicly the price of the order and the minimum size set by the exchange or association." *Proposed Order Execution Rules*, at pp. 24-25. Many of our members believe, however, that the public disclosure of the trader's identity is potentially more damaging than public disclosure of the size of an order.

¹³ Levels 2 and 3 of the Nasdaq quotation reporting system display the current quotes for securities and the names of the market makers who entered them.

¹⁴ The Commission's proposal appears to be similar to a rule recently proposed, but not adopted, by the London Stock Exchange ("LSE"). The rule would have prohibited member firms from placing orders on electronic systems that are superior to quotes published on the LSE's automated system. In rejecting the rule proposal, the LSE apparently concluded that it would significantly restrict competition among markets and restrain the development of competing electronic systems. See Miller, Hensley & O'Brien, *The SEC's new investor-fairness rules, intended to afford the small investor the price opportunities of institutions, could result in reduced competition*, National Law Journal (Dec. 25, 1995) at B5; Cohen, *Stock Exchange Rule May Deter Use of Rival*, Financial Times (Aug. 12, 1995).

¹⁵ As noted in the Commission's release, electronic communications networks "[p]articipants may include investors (retail and institutional) broker-dealers, and market makers." *Proposed Order Execution Rules*, at p. 20.

¹⁶ In addition, the proposal might have the effect of discriminating against high-technology automated trading alternatives and therefore deter market innovations, which have traditionally improved retail executions. See Miller, Hensley & O'Brien, *supra* note 14.

Accordingly, the Institute recommends that the Commission not adopt this aspect of the proposed amendment to the Quote Rule.

One alternative to the proposed amendment to the Quote Rule could be for the Commission to expand the scope of the Intermarket Trading System ("ITS") to include electronic communications networks.¹⁷ In particular, rather than requiring market makers to reflect in their public quotes the bid and offer prices they disseminate through electronic communications networks, the Commission could require that the ITS include the best-priced orders entered into electronic networks and other "markets" that are not currently represented in the ITS.¹⁸

The Institute believes that this approach would be far superior to the Commission's proposal to require market makers to reflect such orders in their public quotes. Most importantly, it would preserve the market makers' anonymity in trading (because they would not be required to adjust their published quote), but would nonetheless result in the public distribution of the priced order. Thus, the ITS could provide for the exposure and interaction of priced orders, without driving market makers from using electronic networks for trading.¹⁹

Moreover, if all priced orders were included in the ITS, it may be possible for market-makers and other participants to provide orders in decimal form, which might result in opportunities for further price enhancements through narrower spreads.²⁰ Finally, if the ITS were changed in this manner,²¹ it would likely become the national clearinghouse for

¹⁷ The "ITS provides facilities and procedures for: (1) the display of composite quotation information at each participating market so that brokers can readily determine the best available price for a particular security, (2) the execution of orders between broker-dealers at respective ITS market centers, and (3) the coordination of market openings among the linked markets." *Market 2000 Report*, at p. AII-4 (footnote omitted).

¹⁸ The ITS does not currently provide linkages among all markets, since it does not include Instinet, the Arizona Stock Exchange, and various other electronic communications networks.

¹⁹ Indeed, the ITS was envisioned for precisely this purpose. The *Market 2000 Report* states:

The ITS Plan responded to the request in the Commission's 1978 Statement that the SROs take prompt steps to link all qualified markets in a comprehensive, efficient, intermarket order routing system.

Market 2000 Report, at p. AII-3 (footnote omitted).

²⁰ See *Proposed Order Execution Rules*, at p. 66 ("Notwithstanding the lack of a comprehensive study by the SROs, the Commission continues to believe that decimal pricing is the next logical step for the markets to pursue to improve transparency and provide opportunities for narrower spreads.") (footnote omitted). The Institute understands that at least one electronic communications network can already accommodate orders priced in decimal form (Instinet's international system).

²¹ As indicated in the Commission's release approving amendments to the ITS Plan, which incorporated the NASD into the ITS:
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information on priced orders. This would allow all market participants to look to one source for comprehensive information with respect to priced orders and limit orders.

III. Proposed Rules for the Display of Customer Limit Orders

A. The Commission's Proposal

The Institute strongly supports the Commission's proposed new rule²² to require specialists and OTC market-makers to display customer limit orders priced better than the specialists' or market-makers' quote. The Institute agrees with the Commission that "[t]he increased transparency of customer limit orders in all markets could produce, among other benefits, spreads that more fully represent buying and selling interest in the market and enhance an investor's ability to monitor execution quality."²³

The Institute recommends, however, that the proposal's *per se* exception for block-sized limit orders (*i.e.*, those orders for at least 10,000 shares of stock with a market value of at least \$200,000) not be adopted.²⁴ We believe that the depth of the limit order display is important for liquidity purposes and therefore that limit orders of any size and dollar amount should be displayed. In addition, allowing for the display of block-sized limit orders would increase the overall transparency of customer limit orders. Accordingly, we recommend that there be no restrictions on the size of an order that can be displayed as a limit order.²⁵

Section 11A(a)(3)(B) of the [Exchange] Act specifically authorizes the Commission, by rule or order, to authorize self-regulatory organizations to act jointly with respect to national market system matters. Rule 11Aa3-2 (the "Plan Rule") implements that section by, among other things, establishing procedures for initiating or approving amendments to national market system plans such as the ITS Plan. Paragraph (b)(2) of the Plan Rule states that the Commission may propose amendments to an effective national market system plan by publishing the text thereof together with a statement of the purpose of the amendments.

Exchange Act Release No. 34-18713 (May 17, 1982). *See also* Conf. Rep. No. 94-229, 94th Cong., 1st Sess., p. 93 (1975).

²² Proposed Securities Exchange Act Rule 11Ac1-4.

²³ *Proposed Order Execution Rules*, at pp. 33-34.

²⁴ Among other things, "[t]he Commission seeks comment on whether the scope of the definition of 'block size' is appropriate, particularly whether the definition should be changed to apply to orders of greater size or market value (*e.g.*, 25,000 shares in NYSE Rule 72(b)). Alternatively, the Commission requests comment on whether orders of block size should be subject to the display requirement." *Proposed Order Execution Rules*, at pp. 44-45.

²⁵ The Institute does, however, support the proposed rule's exception for any limit order that is placed by a customer who expressly requests that the order not be displayed. *Id.*, at pp. 41-42.

The Institute further notes that certain existing exchange rules would serve to diminish the effectiveness of the limit order proposal. For example, the New York Stock Exchange's "clean cross" rule²⁶ allows a member who has orders to buy and sell 25,000 shares or more of the same security to cross those orders at a price that is at, or within, the prevailing quotation without being broken up at the cross price, irrespective of preexisting bids and offers at that price (*i.e.*, the orders can be kept together and given priority at the cross price).²⁷ Thus, an exchange member can execute such a "clean cross" while a public investor's displayed limit order remains unexecuted.²⁸ As an example, assume under the proposed limit order rule that an investor submits a limit order to purchase 100 shares of a security at \$10 per share. If a broker-dealer has an order to buy 25,000 shares of the same security and a matching order to sell 25,000 shares, the order might be crossed and executed at the \$10 per share price. The investor's limit order for 100 shares would not be executed against the sell side of the cross transaction or given priority over the 25,000 share buy order. This will undermine the objectives of the proposed rule, as it will reduce the incentives for investors to submit limit orders, which facilitate price discovery.²⁹

Consequently, the Institute recommends that the Commission consider requiring the exchanges to rescind rules such as the "clean cross" rule that undermine limit order protection.

B. The NASD's Proposal

The NASD's proposed rule changes would, among other things, replace the NASD's Small Order Execution System with a computer facility, called NAqcess. Under the proposed rule changes, customers could request that market makers enter limit orders in the facility of up to 1,000 shares in National Market and SmallCap issues and up to 3,000 shares for Nasdaq 100 issues. The facility would provide for immediate distribution to market makers of limit orders when received, unless all available market makers have already been assigned an order.³⁰

²⁶ New York Stock Exchange Rule 72(b).

²⁷ The rule also requires that neither order be for the account of a member or a member organization. See Exchange Act Release No. 34-31343 (Oct. 21, 1992).

²⁸ The Commission recognized this problem in its adopting release for the "clean cross" rule when it stated: "For example, if a customer left a limit order on the specialist's book at 10:00 a.m., bidding for 500 shares of XYZ at 40, a so-called clean cross could be executed at 10:10 at a price of 40 without satisfying the public customer order." *Id.*

²⁹ As the noted in the Commission's release, "[t]he increased transparency of customer limit orders in all markets could produce, among other benefits, spreads that more fully represent buying and selling interests in the market . . ." *Proposed Order Execution Rules* at pp. 33-34. Indeed, the "lack of a mechanism to provide nationwide agency limit order protection" that allows for "time and price priority to such orders" was cited by the Commission as a "major problem" almost twenty years ago. Exchange Act Release No. 14416 (Jan. 26, 1978) ("Development of a National Market System").

³⁰ The NASD's proposal would also (1) require that a member firm use the NAqcess facility if it is requested to do so by a customer, (2) prohibit a member firm, whether acting as principal or agent, from executing any order at a
(Continued on following page)

While the Institute supports the NASD's efforts to enhance the display and execution of limit orders, we do not believe that they should be subject to unnecessarily restrictive conditions. As discussed in the context of the Commission's proposal, the Institute believes that the proposed rules should not set *per se* eligibility levels for the display and execution of limit orders. The limits in the NASD's proposal are far more restrictive than the "block size" exception set forth in the Commission's proposal. Since, as noted above, we believe that the depth of limit orders available for execution is important for market liquidity, use of the NAqcess facility should not be restricted to those orders below 1,000 or 3,000 shares.³¹

The Institute further believes that it is difficult to evaluate fully the proposed NAqcess system without a better understanding of how the facility will operate in practice. We therefore recommend that the NASD provide for a trial time period in which to test the NAqcess facility.³² This time period would allow market participants to suggest improvements or changes. At the end of the time period, the NASD could seek comment from market participants and then develop a final rule proposal.

IV. Proposed Rule for Price Improvement for Customer Market Orders

The Commission has proposed a new rule that would require specialists and OTC market makers to provide price improvement opportunities for customer orders.³³ The rule would establish a non-exclusive safe harbor, compliance with which would be deemed to satisfy the price improvement obligation. The Institute opposes the proposed new rule because it would discourage the use of limit orders by market participants and therefore is counter to the goals of the Commission's proposed limit order rule, which include narrowing spreads and increasing opportunities for best execution.

Under the proposed safe harbor, prior to executing a customer market order in a security, the specialist or market maker would be required to expose the order at an improved

price inferior to any limit order that the firm is able to see in the NAqcess limit order file, and (3) require that a member provide price protection equivalent to or better than that which an order would have received if it had been executed in the NAqcess facility. *NAqcess Proposal*, at pp. 25-35.

³¹ As with the Commission's limit order proposal, the Institute believes that the NASD's proposal should provide an exception for any limit order that is placed by a customer who expressly requests that the order not be displayed.

³² For example, the NASD might test the facility during an eighteen month time period. *See id.*, at pp. 12-13. ("The NASD proposes to monitor the limit order size requirement carefully in the initial eighteen months of NAqcess operation and may choose to expand the eligibility size of limit orders, if experience demonstrates such expansion to have merit.")

³³ Proposed Securities Exchange Act Rule 11Ac1-5.

price and provide the customer with a guaranteed execution at the "stop" price. Specifically, the specialist or market maker would be required to stop the customer order at the national best bid and offer ("NBBO"), and publish and maintain for 30 seconds, a bid or offer on behalf of the customer at a quote that is at least one minimum variation away from the stop price on the opposite side of the market.³⁴

The Institute believes that the proposed rule would undermine the Commission's important efforts with respect to the display and execution of customer limit orders. Assume, for example, that the NBBO for a particular security is 20-20 $\frac{1}{4}$. A customer that wishes to sell 100 shares of the security at 20 would have no reason under the proposed rule not to enter a market order. In such a case, a market maker's quote for the security would be required to be for at least the size of the customer order and at a price one minimum variation away from the stop price on the opposite side of the market. If the order was not executed at the new quote it would be filled at the stop price. Thus, the customer with a market sell order would be guaranteed execution at the stop price of 20³⁵ with a risk-free option that the order might be executed at a higher price during the 30 seconds in which the order is published and maintained by the market maker.

In this manner, the proposed rule would lessen incentives to submit limit orders on the part of market participants that would be willing to buy at a higher price or sell at a lower price than that reflected in the NBBO. In the above example, a trader that was willing to buy the shares at 20 $\frac{1}{8}$ could do so without having to submit a limit order and have his or her order executed ahead of the party that submitted the limit order to buy at 20. It would be far better from the perspective of all market participants if the trader had an incentive to enter a limit order at 20 $\frac{1}{8}$. Indeed, the Commission's proposal appears to be premised on the notion that there are "hidden orders" that would be exposed by the price improvement requirement. The investing public, however, would be better served if orders were discouraged from being "hidden" in the first place by granting priority only to those orders that are public.

The Institute also is concerned that the proposed rule may have a disruptive effect on the market by increasing the volatility of quotations.³⁶ We believe that a 30 second delay in execution of transactions – during which the price may vary from a price one minimum variation away from the stop price and the stop price – will result in quotation volatility in the

³⁴ *Proposed Order Execution Rules*, at pp. 52-59.

³⁵ According to the Commission's release, "the specialist or market maker would fill the customer order at the stop price for the lesser of: (1) the full number of shares of the order; or (2) the size associated with the NBBO at the time the order was stopped." *Id.*, at pp. 54-55.

³⁶ See Remarks of Steven M.H. Wallman, Commissioner, U.S. Securities and Exchange Commission, Before the Securities Traders Association (Oct. 22, 1995), at pp. 13-14.

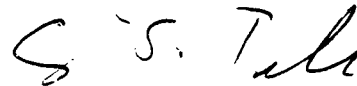
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market, which may be disruptive for market participants.³⁷ Accordingly, the Institute believes that the proposed new rule should not be adopted.

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The Institute appreciates the opportunity to express its views on this matter. If you have any questions concerning our comments, please contact the undersigned at 202/326-5815 or Alex Gavis at 202/326-5923.

Very truly yours,



cc: Chairman Arthur Levitt
Commissioner Steven M.H. Wallman
Mr. Richard R. Lindsey, Director, Division of
Market Regulation
Mr. Barry P. Barbash, Director, Division of
Investment Management
Mr. Richard Ketchum, Executive Vice President and
Chief Operating Officer, National Association of
Securities Dealers, Inc.

³⁷ The Commission's release states that "[t]he exposure procedure would not apply in circumstances where the order is for a security with a spread between the NBBO greater than four times the minimum variation to avoid excessive quotation volatility resulting from the exposure requirement in markets with a wide spread." *Id.* at p. 55 (footnote omitted). The Institute is concerned that there may nonetheless be quote volatility where the spread is less than four times the minimum variation, given the significant volume of transactions in the market that might be affected by the rule.