MEMO# 11835

April 25, 2000

DRAFT INSTITUTE COMMENT LETTER ON SEC MARKET FRAGMENTATION CONCEPT RELEASE

1 See Memorandum to Equity Markets Advisory Committee No. 9-00 and SEC Rules Committee No. 26-00, dated February 25, 2000. [11835] April 25, 2000 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 29-00 SEC RULES COMMITTEE No. 65-00 RE: DRAFT INSTITUTE COMMENT LETTER ON SEC MARKET FRAGMENTATION CONCEPT RELEASE ____ As we previously informed you,1 the Securities and Exchange Commission has issued a Concept Release requesting comment on a broad range of issues relating to market fragmentation. The Institute has prepared a draft comment letter (a copy of which is attached) on the Concept Release. The comment letter first addresses our concerns with current market structures, in particular those that have contributed to fragmentation. The letter then discusses the Institute's recommendations to address these concerns. Our principal recommendation is that the Commission should establish a price/time priority rule for displayed orders across all markets. I. Concerns Regarding Fragmentation The letter states that fragmentation adversely affects the ability of customer orders to interact with one another as broadly as possible and can therefore force mutual funds and other investors to look to several different sources to find sufficient liquidity to effectively complete a trade, especially a large trade, at the best price. The letter then discusses several factors which can cause fragmentation, including internalization, the lack of priority rules across markets, inadequate linkages among markets, and inadequate transparency. In particular, the letter states that when a broker-dealer internalizes its orders, those orders are not exposed to other orders in the marketplace, which can adversely affect liquidity and transparency. The letter also questions whether and to what extent brokers can adequately fulfill their duty of best execution if they internalize order flow, as orders that are routed pursuant to internalization arrangements may not receive as favorable executions as orders not subject to such arrangements. The letter also notes that currently there are no rules providing for intermarket time priority for investor limit orders. Therefore, a market participant that publicly displays a limit order setting a new best price in a market is not guaranteed that the order will ever be filled as that order has no priority across markets. Finally, the letter discusses the 2weaknesses associated with the two primary linkages in the securities markets, the Intermarket Trading System in the listed market and SelectNet in the over-the-counter market, and the lack of transparency of prices in the securities markets and its effect on liquidity and the price discovery process. II. Institute Recommendations on Market Structure The letter states that after careful consideration, the Institute has concluded that the best way to address the shortcomings in the securities markets is to mandate price/time priority across all markets. This will ensure that those investors that are

displaying limit orders will be afforded protection and priority for such orders and will thus realize the benefits of displaying these orders, thereby encouraging further use of limit orders. Therefore, the letter states that the Institute favors the sixth option proposed by the Commission in the Concept Release, which would provide price/time priority to all displayed orders, as the preferred option for structuring the securities market. A. Price/Time Priority The letter states that a price/time priority rule will rectify the problem of an investor placing a limit order that sets the new best bid or offer in one market and not having that order executed while other market centers trade at that price. The Concept Release requests comment on whether a market structure employing price/time priority should incorporate a reserve size function and whether there should be any exceptions from a price/time priority requirement for block transactions or for intra- market agency crosses at the NBBO. The letter states that markets should be able (but not required) to provide for a reserve size function. The letter further states that while Institute members, as institutional investors, frequently make use of block transactions and intra-market agency crosses at the NBBO, we believe it is important that there be consistent rules in the market and that orders of any size and dollar amount be required to interact with one another. 1. Concerns Raised Regarding Price/Time Priority The letter also addresses several objections that have been raised to a system mandating price/time priority. For example, opponents of price/time priority argue that such a system would require a single industry utility to operate the system, thereby creating a single point of failure that could shut down all securities markets. The letter states that the Institute does not believe that a price/time priority system needs to be structured in this manner and that the Commission should permit markets themselves to determine how to structure linkages that would provide access to all markets and route orders according to price/time priority. Arguments also have been put forth that a price/time priority system removes incentives for intermarket competition. The letter states that we believe that there will still be a variety of ways in which markets can, and will, seek to distinguish themselves from other market centers within the broad framework of a price/time priority system, e.g., through anonymity, reserve book features, reliability, cost of execution. Finally, many market participants contend that price/time priority will be illusory in a decimal environment because even if an investor places a price setting limit order in one market, a participant in another market can simply provide for price improvement by a de minimis amount and obtain priority over that investor's order while risking, in many cases, no more than an additional penny. The letter states that the Institute disagrees with this argument and that even small price improvements can benefit investors. 32. Alternatives to Intermarket Price/Time Priority The letter also addresses several alternatives to intermarket price/time priority proposed by the Commission in the Concept Release. For example, under one version, the Commission would provide priority only to customer limit orders and would not include broker-dealer principal trades. The letter states that we see no purpose in drawing these distinctions between customer orders and proprietary orders and that both of these types of orders provide liquidity to the markets and facilitate price discovery. Under another option proposed by the Commission, the Commission would establish intermarket trading priorities that granted time priority only to the first limit order or dealer quotation that improved the NBBO for a security. The letter states that we believe that it is inadequate to grant time priority only to the first trading interest to improve the NBBO and that subsequent orders or quotations that match the improved price also are valuable to the markets as they indicate greater depth at that price. B. Other Recommendations The letter also discusses several other Institute recommendations for a revised market structure including a price improvement requirement and a requirement for increased transparency. In particular, one of the options suggested by the Commission in the Concept Release would require that broker- dealers only internalize customer order flow if they provide for price improvement, i.e., a price that is better than the national best bid or offer against which the order might otherwise be executed. The letter states that the Institute strongly supports such a requirement and believes that this requirement would promote the interaction of orders in the securities markets and discourage internalization, or at least help ensure that investors receive a fairer price for internalized orders. In addition, the letter states that increased transparency and depth of book also are vital elements to an effective market structure with price/time priority. We therefore recommend that the Commission adopt a requirement that market centers make available for public viewing a minimum amount of their limit order book, if not the entire book. If you have any comments on the draft Institute letter, please provide them to the undersigned by phone at (202) 371-5408, by fax at (202) 326-5839, or by e-mail at aburstein@ici.org no later than Monday, May 1. Ari Burstein Assistant Counsel Attachment

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