INVESTMENT COMPANY INSTITUTE
The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

MEMO# 11861

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REVISED DRAFT INSTITUTE COMMENT LETTER ON SEC MARKET FRAGMENTATION CONCEPT RELEASE

1 See Memorandum to Equity Markets Advisory Committee No. 29-00 and SEC Rules Committee No. 65-00, dated April 25, 2000. 1 [11861] May 8, 2000 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 30-00 SEC RULES COMMITTEE No. 69-00 RE: REVISED DRAFT INSTITUTE COMMENT LETTER ON SEC MARKET FRAGMENTATION CONCEPT RELEASE ____ As we previously informed you,1 the Institute has prepared a draft comment letter on the Securities and Exchange Commission's Concept Release regarding market fragmentation. The Institute has prepared a revised draft comment letter (a copy of which is attached) that reflects members' comments, in particular, comments provided by members of the Equity Markets Advisory Committee during a conference call regarding the draft letter. In reviewing the revised draft comment letter, members are asked to focus on those changes from the prior draft that relate to the Institute's recommendations on market structure. In particular, the revised letter now divides the Institute's principal recommendations into two categories – short-term and long-term recommendations. In the long term, the letter states that we believe that the Commission should establish an intermarket price/time priority rule for displayed orders. The letter, however, states that we recognize that such a price/time priority based system will only prove effective if there exist, among other things, systems that are capable of effectively routing orders between markets and standards for order execution within markets. Consequently, we also recommend that the Commission implement other changes more immediately. These include requiring greater transparency of limit orders, a price improvement rule for internalized orders, and rules requiring price/time priority within markets. The prior draft comment letter did not distinguish between long-term and short-term goals and only stated that our principal recommendation is that the Commission establish a price/time priority rule for displayed orders across all markets. The letter discussed a price improvement requirement and a requirement for increased transparency, but only in the context of other recommended actions for the Commission to take and did not recommend that the Commission take those actions apart from the establishment of an intermarket price/time priority based system. Finally, the prior draft comment letter only briefly discussed intramarket price/time priority as a fallback position if the Commission could not implement price/time priority across all markets on a timely basis. Set forth below is a summary of the significant changes to the draft letter. 2A. Short-Term Recommendations 1. Transparency and Depth of Book The revised letter states that the Institute strongly supports increasing the exposure of limit orders to investors and believes that market centers should make available for public viewing a minimum amount of their limit order book, if not the entire book. In addition, the letter states that the

Institute was pleased that the Commission held a roundtable on this issue to create a dialogue among market participants and noted that the Institute looks forward to working with the Securities Industry Association and its members, which agreed to form a joint industry group with the Institute to examine issues regarding limit order transparency. 2. Price Improvement The letter also states that the Institute strongly supports a price improvement rule that would allow broker-dealers to internalize customer order flow only if they provide for a price that is better than the national best bid or offer against which the order might otherwise be executed. 3. Price/Time Priority Within Markets Finally, the letter states that until certain conditions have been satisfied that will allow for intermarket price/time priority, the Commission should mandate price/time priority within markets. Mandating price/time priority on an intramarket basis would ensure that a limit order entered on a given market will be filled prior to a limit order on that same market that is entered at the same price but later in time. B. Long-Term Recommendation - Intermarket Price/Time Priority The letter states that while each of the short-term recommendations would improve the functioning of our markets by reducing fragmentation and encouraging the display of priced orders, the Institute believes that they would not sufficiently address the issue of how to provide for the interaction of orders entered into different markets. Therefore, the Institute concluded that the sixth option set forth in the Concept Release establishing intermarket price/time priority should be adopted. The letter states that we believe, however, that such a system could only be effectively implemented once certain conditions for and elements of an intermarket price/time priority based system are established. Among other things, the letter states that the Commission should permit markets and market participants themselves to determine how to structure linkages that would provide access to all markets and route orders according to price/time priority. Ideally, there should be a multitude of entities that provide these services to investors that would operate on a “real time” basis, with orders being routed in accordance with price/time priority and with the priority being immediately updated to reflect executions and cancelled orders. The letter states that we are confident that the technology to make this possible can and will be developed, but we would not recommend that the Commission require intermarket price/time priority until this has occurred. The letter also states that markets that participate in an intermarket price/time priority based system should be required to meet certain standards with respect to their order execution capabilities. Otherwise, a market participant could be forced to send its order to a market that, for example, is slow in executing orders. This could harm investors, as other orders entered in the markets could be cancelled (e.g., in a fast moving market) while they are waiting for the first order to be executed. 3Therefore, only orders entered into markets that meet such standards would be entitled to protection on a price/time priority basis and, conversely, markets that do not meet the standards should be required to prominently disclose this fact and the consequences to investors entering orders into these markets. In addition, the letter states that an intermarket price/time priority system would require the adoption first of the short-term recommendations, in particular, the display of a significant depth of orders. The letter emphasizes that such display will only be meaningful if market centers are not permitted to charge fees for accessing these orders that are inappropriately high. Consequently, the letter recommends that the Commission must ensure that there are appropriate safeguards in place to prevent dominant market centers from charging fees that are de facto barriers to transparency. Finally, the letter recommends that an intermarket price/time priority rule apply only during normal trading hours. Otherwise, there will be difficult, if not insurmountable, problems in determining how to treat orders entered during the trading day in an after-hours trading environment, particularly under very different market conditions. As in the prior draft comment letter, the revised letter then discusses concerns raised regarding price/time priority and alternatives to intermarket price/time priority proposed by the Commission in the Concept Release. If you have any comments on the revised draft Institute letter, please provide them to the undersigned by phone at (202) 371-5408, by fax at (202) 326-5841, or by e-mail at aburstein@ici.org by close of business on Wednesday, May 10. Ari Burstein Assistant Counsel Attachment