MEMO# 11674

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SEC ISSUES NYSE PROPOSED RULE CHANGE TO RESCIND RULE 390 AND REQUEST FOR COMMENT ON MARKET FRAGMENTATION

1 Securities Exchange Act Release No. 42450 (February 23, 2000) ("Release"). 1 [11674] February 25, 2000 TO: COMPLIANCE ADVISORY COMMITTEE No. 12-00 EQUITY MARKETS ADVISORY COMMITTEE No. 9-00 SEC RULES COMMITTEE No. 26-00 RE: SEC ISSUES NYSE PROPOSED RULE CHANGE TO RESCIND RULE 390 AND REQUEST FOR COMMENT ON MARKET FRAGMENTATION

____ The Securities and Exchange Commission ("SEC") has issued a proposed rule change filed by the New York Stock Exchange ("NYSE") to rescind NYSE Rule 390 as well as a concept release requesting comment on a broad range of issues relating to market fragmentation.1 The proposed rule change and the concept release are summarized below. Rescission of NYSE Rule 390 The purpose of the NYSE proposed rule change is to rescind NYSE Rule 390. Subject to several exceptions, NYSE Rule 390 prohibits members and their affiliates from effecting transactions in NYSE-listed securities away from a national securities exchange, thereby precluding NYSE member firms from internalizing their agency order flow by trading as dealer or principal against it. According to the Release, the NYSE believes that the anti-internalization concerns addressed by Rule 390 are significant enough that they should not be addressed by a series of similar rules of individual market centers, such as the NYSE's Rule 390. Instead, the NYSE urges that the SEC, in approving the rescission of Rule 390, adopt a market-wide requirement that broker-dealers not be permitted to trade against their customer orders unless they provide a price to the order that is better than the national best bid or offer ("NBBO") against which the order might otherwise be executed. The NYSE believes that such a requirement would assure that investors receive the fairest pricing of their internalized orders, and would eliminate broker-dealer conflicts of interest in trading against their own customer order flow to capture the spread. The NYSE stated in the Release that if a broker-dealer is trading as principal against agency orders, serious concerns arise about whether agency orders are being afforded an opportunity to receive the best possible price that may be available. The NYSE also believes that broker-dealer internalization raises concerns about market fragmentation, as public orders are denied the opportunity to interact with one another. The NYSE believes that broker-dealer internalization results in the execution of "captive" customers' orders in such a manner as to insulate them from meaningful interaction with other buying and selling interest. According to the 2 The concept release also states that commenters should be aware that decimal pricing of securities will soon be introduced to the markets and a reduced quoting increment could significantly change current market dynamics. Commenters therefore should consider the extent to which their comments will be affected by the initiation of decimal pricing. 2 NYSE, this not only decreases competitive interaction among markets and market makers, but also isolates segments of the total public order flow and impedes competition among orders, with no price benefit to the orders being internalized. Comments on the NYSE proposed rule change are due to the SEC no later than March 20, 2000. If you have any comments you would like the Institute to consider including in a comment letter on the NYSE proposed rule change, please provide them to Ari Burstein by phone at (202) 371-5408, by fax at (202) 326-5839, or by e-mail at aburstein@ici.org no later than March 13. Fragmentation Concept Release The SEC also issued a concept release requesting comment on issues relating to market fragmentation. The concept release first provides an overview of the current market structure and a discussion of the SEC's regulatory role in overseeing the national market system. The concept release then requests comment on the general effect of fragmentation on the markets, including the extent to which fragmentation of the buying and selling interest in individual securities among multiple market centers is a problem in today's markets and whether fragmentation has reduced the capacity of the markets to withstand a major market break in a fair and orderly fashion. In addition, the concept release requests comment on whether fragmentation in the listed equity markets is likely to increase with the elimination of off-board trading restrictions, such as NYSE Rule 390. The concept release also requests comment on several issues relating to internalization and payment for order flow. For example, the concept release requests comment on the proportion of order flow that currently is subject to internalization and payment for order flow arrangements and whether investor market orders that are routed pursuant to internalization and payment for order flow arrangements are executed as favorably as orders not subject to such arrangements. The concept release also requests comment on whether the existence of these types of arrangements reduces the efficiency of the market as a whole so that all market orders receive less favorable executions than they otherwise would if there were no internalization or payment for order flow. Finally, the concept release requests comment on whether increased fragmentation of trading interest reduces the opportunity for best execution of investor limit orders.2 The concept release states that if action to address fragmentation is determined to be necessary or appropriate, a variety of approaches could be considered. The SEC suggests six options and specifically requests comment on each one. The SEC also encourages commenters to submit any additional options for addressing fragmentation that they consider feasible. 1. Require Greater Disclosure by Market Centers and Brokers Concerning Trade Executions and Order Routing The SEC’s first option would require greater disclosure by market centers and brokers concerning their trade executions and order routing. For example, all market centers could be required to provide uniform, publicly available disclosures to the SEC concerning all aspects of their trading and their arrangements for obtaining order flow including the nature of their order flow, their effective spreads for market orders for different types of securities, their percentage of market orders that receive price improvement, their speed in publicly displaying limit orders, and their fill rates for different types of limit orders. Brokers, in turn, could be required to provide disclosures to their customers concerning the proportion and types of orders that are routed to different market centers, their arrangements with market centers for routing customer orders, and the results they have obtained through these arrangements. 2. Restrict Internalization and Payment for Order Flow The SEC’s second option would restrict internalization and payment for order flow arrangements by reducing the extent to which market makers trade against customer order flow by matching other market center prices. This option would be similar to the plan suggested by the NYSE in their proposed rule change to rescind Rule 390 where a broker-dealer could buy from or sell to its customer only at a price that was better than the NBBO for the particular security. The concept release states that this type of prohibition could be extended to all market centers that receive orders pursuant to a payment for order flow arrangement, in addition to internalizing broker-dealers. 3. Require Exposure of Market Orders to Price Competition The third suggested option would require that all market centers expose their market and marketable limit orders in an acceptable way to price competition. The concept release provides examples of acceptable exposure including exposing an order in a system that provides price improvement to a specified percentage of similar orders over a specified period of time or having a market maker, before executing an order as principal in a security whose quoted spread is greater than one minimum variation, publish for a specified length of time a bid or offer that is one minimum variation better than the NBBO. 4. Adopt an Intermarket Prohibition Against Market Makers Trading Ahead of Previously Displayed and Accessible Investor Limit Orders The fourth option would establish intermarket trading priorities as a means to address fragmentation. The concept release states that one option would be to adopt an intermarket prohibition against market makers using their access to directed order flow to trade ahead of investor limit orders that were previously displayed by any market center and accessible through automatic execution by other market centers. Under this option, each market center would be responsible for providing notice to other market centers of the price, size, and time of its investor limit orders that were entitled to priority, as well as participate in a linkage system that allowed automatic execution against the displayed trading interest. To execute a trade as principal against customer order flow, market makers would be required to satisfy, or seek to satisfy, investor limit orders previously displayed and accessible at that price in all market centers. 5. Provide Intermarket Time Priority for Limit Orders or Quotations that Improve the NBBO The fifth option would establish intermarket trading priorities that granted time priority to the first limit order or dealer quotation that improved the NBBO for a security. To qualify for this priority, the limit order or quotation would have to be widely displayed and accessible through automatic execution. Only the first trading interest at the improved price (“Price Improver”) would be entitled to priority. No market center could execute a trade at the improved or an inferior price unless it undertook to satisfy the Price Improver. Subsequent orders or quotations that merely matched the improved price would not be entitled to any enhanced priority. 6. Establish Price/Time Priority for All Displayed Trading Interest Finally, in the sixth option, the SEC would order the establishment of a national market linkage system that provides price/time priority for all displayed trading interest. Under this option, the displayed orders and quotations of all market centers would be displayed in the national linkage system ("NLS"). All NLS orders and quotations would be fully transparent to all market participants, including the public, and orders and quotations displayed in the NLS would be accorded strict price/time priority. Market makers could execute transactions as principal only if they provided price improvement over the trading interest reflected in the NLS. The concept release states that public access to the NLS would be provided through self-regulatory organizations, alternative trading systems, and broker-dealers and that the NLS would be administered and operated by a governing board made up of representatives from the public and relevant parts of the securities industry. Comments on the fragmentation concept release are due to the SEC no later than April 28, 2000. If you have any comments you would like the Institute to consider including in a comment letter on the concept release, please provide them to Ari Burstein by phone at (202) 371-5408, by fax at (202) 326-5839, or by e-mail at aburstein@ici.org no later than April 7. Ari Burstein Assistant Counsel Attachment