

MEMO# 11503

December 30, 1999

SEC ADOPTS AMENDMENTS TO THE INTERMARKET TRADING SYSTEM PLAN TO EXPAND THE ITS LINKAGE TO ALL LISTED SECURITIES

1 Securities Exchange Act Release No. 42212 (December 9, 1999), 64 FR 70297 (December 16, 1999). 2 Current signatories to the ITS Plan include the American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, Cincinnati Stock Exchange, National Association of Securities Dealers, New York Stock Exchange, Pacific Exchange, and Philadelphia Stock Exchange (collectively, "ITS Participants"). 3 The CAES is a computer assisted execution system that enables participating firms to route their orders for listed securities through the system to obtain automatic executions against quotations of third market makers. 4 Currently, only Securities Exchange Act Rule 19c-3 securities are ITS eligible. Rule 19c-3 allows a security that was listed on an exchange after April 26, 1979 to trade "off the floor" of an exchange on which it was listed. 5 The term "third market" refers to the OTC market in listed securities. 1 [11503] December 30, 1999 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 42-99 SEC RULES COMMITTEE No. 114-99 RE: SEC ADOPTS AMENDMENTS TO THE INTERMARKET TRADING SYSTEM PLAN TO EXPAND THE ITS LINKAGE TO ALL LISTED SECURITIES

The Securities and Exchange Commission ("SEC") is adopting amendments¹ to the plan governing the operation of the Intermarket Trading System ("ITS Plan").² The amendments expand the NASD's ITS/Computer Assisted Execution System ("CAES")³ linkage to all listed securities, including non-Rule 19c-3 securities.⁴ The amendments become effective on February 14, 2000. The SEC stated that it believes that it is necessary to expand the ITS/CAES linkage to all listed securities in order to create a national market system linking the exchanges and the over-the-counter ("OTC") market. When the SEC originally approved the ITS linkage, it did so only for Rule 19c-3 securities. At that time, however, the SEC only intended the approval to be the first step toward a more expansive linkage. Since the original approval of the ITS, there has been a marked increase in the level of trading in, and several significant improvements to, the third market.⁵ Specifically, any NASD member that acts in the capacity of an OTC market maker must provide continuous two-sided quotations in certain exchange-listed securities. In addition, the NASD prohibits third market makers from trading ahead of their own customer limit orders. Finally, the Limit Order Display Rule requires third market makers to display customer limit orders in their quote if those orders improve the quote. In light of these changes, the SEC stated that there is no longer any need for the historical distinction between Rule 19c-3 and non-Rule 19c-3 securities in the ITS/CAES linkage. The SEC² believes that expanding the ITS linkage will increase a broker-

dealer's ability to obtain the best price available for the customer, promote competition in listed securities, help ensure more equivalent access to the markets, and provide for additional liquidity and more efficient executions. In the proposing release, the SEC requested comment on whether ECNs should be required or allowed to participate in the ITS, and if so, what form that participation should take. The SEC stated in the adopting release that most of the commenters who discussed the issue supported ECN access to the ITS in some form. The SEC also stated that it believes that, in order to further the goals of the national market system, ECNs trading in listed securities should be linked to the ITS and that the ITS should not prevent efficient electronic routing between markets. The amended ITS Plan, however, does not include ECNs. The SEC noted that ITS Participants have begun a dialogue about the parameters of ECN access to the ITS and strongly urged ITS Participants to continue to discuss the issue and reach a resolution. In the proposing release, the SEC also proposed to eliminate the requirement that amendments to the ITS Plan be approved unanimously. In the adopting release, the SEC stated that it has decided to defer consideration of that proposal at this time and plans to deal with this and several other larger issues relating to market structure in an upcoming concept release. Ari Burstein
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