

**MEMO# 11748**

March 21, 2000

# **REMARKS OF SEC CHAIRMAN LEVITT ON TRANSPARENCY, DECIMALIZATION, MARKET LINKAGES, AND MARKET FRAGMENTATION**

[11748] March 21, 2000 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 18-00 SEC RULES COMMITTEE No. 45-00 RE: REMARKS OF SEC CHAIRMAN LEVITT ON TRANSPARENCY, DECIMALIZATION, MARKET LINKAGES, AND MARKET FRAGMENTATION

In a recent speech, SEC Chairman Levitt discussed the "seismic shifts" taking place today in our securities markets and their implications for the future. His remarks focused on transparency, decimalization, market linkages, and market fragmentation. A copy of Chairman Levitt's speech is attached and is summarized below. Transparency Chairman Levitt noted that today, as a result of the steps the SEC has taken in recent years towards more transparent, better linked markets, by and large the best dealer quotes and customer limit orders can be seen and accessed by all market participants, thereby fueling price competition. In the view of Chairman Levitt, limit orders, which he described as "the building blocks of transparency," serve a critical market function by promoting price discovery through revealing the supply and demand for a security. This, in turn: increases the information available to the overall market; allows all market participants to better determine prices; and helps level the playing field between dealers and the investing public. Recently, however, SEC examiners have gathered information indicating that limit orders are being mishandled by market intermediaries. As an example, he noted that on one equity exchange, at least one out of six limit orders was not properly displayed. Due to the fact that he is "deeply troubled by this apparent disregard for customer orders and systemic competition," he has asked the Office of Compliance Inspections and Examinations together with the Office of Economic Analysis to prepare within the next 45 days a public report that analyzes the display of limit order in our equity and options markets, including the adequacy of the markets' surveillance and disciplinary programs for the Limit Order Display Rule. Decimalization Chairman Levitt described decimal pricing as "an event on the horizon that will truly be a watershed for our markets," and noted that it will benefit investors -- particularly small investors using market orders -- by reducing spreads and making prices more efficient for investors. Notwithstanding this, he expressed two potential concerns with decimalization. First, it may provide an incentive for market makers and other professionals to step ahead of existing orders, thereby resulting in investor limit orders going unexecuted and investors' incentives to place limit orders being diminished. Second, it may obscure liquidity. He noted that, today, most market participants can see only the "top" of a market's limit order book -- i.e., the single best

quote available. He described this as "seeing the tip of an iceberg -- and having no idea how much rests below." Without greater transparency, decimalization "could become more difficult in a world of pennies." After noting that the NYSE, Nasdaq, and some ECNs have taken steps to increase the transparency of their books, he encouraged all market participants "to move toward open books across all markets." According to Levitt, "[n]ow is the time for a voluntary private sector initiative in this important area . . ." While acknowledging that some customers would prefer not to have their limit orders displayed, and "the choice should remain with investors -- not market intermediaries," he stated that "the ability of all investors to see the depth of supply and demand in any stock would be a giant step towards a true National Market System" and "a step that our markets should take now, before the uncertainty of decimalization is upon us." He has, therefore, asked the Division of Market Regulation to take the lead on facilitating a dialogue on this issue by hosting a public roundtable with representatives of all markets, dealers, market data vendors, and other interested parties. Intermarket Linkages Chairman Levitt described the need for direct intermarket linkages as "compelling." He noted that they further the goal of a National Market System by making it practical for brokers to achieve best execution and they help promote price equilibrium across markets, thereby enhancing market efficiency. While, in the past, the Commission has played a limited role in this area, he expects the Commission to "exercise increasingly active oversight of these linkages in the near future." According to Levitt, "every market institution" should "commit their resources first to technology -- before marketing campaigns or dealer benefits." Market Fragmentation Finally, Chairman Levitt expressed concern that some of our markets are becoming increasingly isolated from buyers and sellers in other markets. He expressed particular concern that internalization of market orders and payment for order flow may discourage broker-dealers from competing through quotes with the rest of the market. Because there is not agreement on how to address this concern, the Commission recently released a concept release on market fragmentation. Levitt emphasized that, while the Commission has not yet determined what, if any, regulatory action should be taken, any action taken by the Commission in this area "must pass one acid test: competition among market centers must remain vigorous and dynamic." Ari Burstein Assistant Counsel Attachment