The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

September 22, 2000

Comment Letter on SEC Execution and Order Routing Practices Proposal, September 2000

September 22, 2000

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Stop 6-9
Washington, DC 20549

Re: Disclosure of Order Routing and Execution Practices
(File No. S7-16-00)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on proposed Rules 11Ac1-5 and 11Ac1-6 under the Securities Exchange Act of 1934, to require disclosure of order routing and execution practices.[2] The proposed rules are in response to the concept release on market fragmentation issued by the Commission in February 2000,[3] which requested comments on six potential options to address fragmentation, ranging from increased disclosure of order routing and execution practices, which the proposed rules would implement, to the establishment of a national market linkage system that mandates price/time priority for all displayed trading interest.

As we stated in our comment letter on the Concept Release,[4] the Institute supports greater disclosure by market centers and brokers concerning their trade executions and order routing and believes that the disclosure approach set forth in the Concept Release should be incorporated into any changes to the structure of the equity markets adopted by the Commission. We also stated in our earlier letter, however, that disclosure alone would not be sufficient. Although increased disclosures may enable investors to make more informed judgments concerning the quality of executions provided by their brokers, this option alone would not facilitate the interaction of those orders with other orders in the market.

Nevertheless, the Institute believes that increased disclosures could increase competition in the securities markets and therefore supports the proposed disclosure rules. At the same time, however, we urge the Commission to consider other changes to strengthen price competition within existing market structures, including several of the alternatives discussed in the Concept Release for addressing fragmentation, particularly those relating to market linkages and price/time priority across all markets. As we stated in our comment letter on the Concept Release, fragmentation adversely affects the ability of customer orders to interact with one another as broadly as possible, which in turn reduces transparency and liquidity and causes spreads to be wider than they otherwise would be.

The Institute also believes that the Commission should adopt a trade-through disclosure requirement for the equities markets, similar to that proposed for the options markets. Such a requirement would promote price priority by creating an incentive for market participants to develop methods of access to avoid trade-throughs and encouraging participation in a linkage plan.

Our comments on proposed Rules 11Ac1-5 and 11Ac1-6 and on a trade-through disclosure requirement for the equities markets are set forth below.

A. Disclosure of Order Execution Information—Proposed Rule 11Ac1-5

Proposed Rule 11Ac1-5 would require market centers to prepare and make available to the public monthly electronic reports that would include information on execution quality on a security-by-security basis. The Institute supports this proposal.

Currently, it can be very difficult to obtain significant and meaningful data on the execution quality of market centers. In the absence of such data, it is difficult to compare execution quality across markets. The Institute therefore supports the proposed approach of adopting uniform statistical measures of execution quality, divided into subcategories based on security, order type, and order size.[5] In particular, the Commission should require market centers to prepare disclosures on a stock-by-stock basis and not require shorter reports with disclosures that are summarized across many stocks. Different stocks can trade very differently and it would be difficult to objectively categorize groups of stocks for execution purposes.

As the Proposing Release notes, it is important to ensure that third parties will have sufficient interest in collecting and summarizing the electronic reports so that investors will have reasonable access to the information. We agree with the Commission that given the volume of data to be included in the electronic reports by market centers, most individual investors likely would not be able to digest the reports themselves. The more user-friendly the reports prepared by market centers, the easier it will be for third parties, such as analysts, consultants, and the financial press, to summarize the data contained therein.

The Proposing Release sets forth an alternative approach under which market centers would be required to make available electronic files with raw data on an order-by-order basis, which analysts could then use to calculate the statistical measures of execution quality that they consider appropriate. We do not believe that the proposed alternative would generate useful information for investors. In addition, given the large amount of data that market centers would generate, third parties likely would find it difficult to collect and summarize it. We therefore recommend that the Commission mandate specific statistical measures for market centers to follow.

1. Scope of the Rule

The Institute generally supports the scope of the proposed rule. The Commission requested comment on whether the rule should exclude market centers that execute relatively few orders in national market system securities in total, or eliminate the disclosure requirement for individual securities in which a market center executed relatively few orders. We do not believe that there should be any exceptions to the proposed disclosure requirements. The objectives of the rule apply equally to all market centers and with respect to all securities. Any exceptions provided in the rule would be arbitrarily crafted and could result in depriving investors of meaningful information.

The definition of "covered order" under the proposed rule only would apply to market orders or limit orders that are received by a market center during the time that a consolidated BBO is being disseminated. "Covered orders" therefore would exclude any orders for which the customer requested special handling for execution including, among other things, orders to be executed at a market opening or closing price. As the Commission recognizes, the quality of execution of market opening orders in the Nasdaq market has been an issue of significant concern to market participants. Information on the quality of execution at the opening would assist market participants in determining how to trade securities at the opening of the market. We therefore believe that the rule should mandate disclosure of information intended to measure the quality of execution of market opening orders, as well as data regarding orders executed prior to the open.

In addition, a "covered order" would apply only to securities that are designated as a national market system security under Rule 11Aa2-1 under the Exchange Act. This designation does not apply to Nasdaq SmallCap securities. The Proposing Release requested comment on whether these securities should be covered by the proposed rule. We believe that they should be. As noted above, the objectives of the rule apply equally to all securities. Absent a compelling reason to not cover Nasdaq SmallCap securities, the rule should be modified to include them.

2. Required Information

Proposed Rule 11Ac1-5 would require that market center reports be categorized by order type, order size, and security. The Institute generally supports the proposed categorization of the proposed information, although we have comments on several aspects of the proposed required information.

First, under the proposed rule, information would be required regarding the "average realized spread." The average realized spread would be calculated by comparing the execution price of an order with the midpoint of the consolidated BBO as it stands thirty minutes after the time of order execution. The Proposing Release does not provide an explanation of why thirty minutes was determined to an appropriate time in which to judge the average realized spread of an order. We recognize that the market needs time to "recover" after an order is executed, especially in the case of a security that may not trade frequently. In that instance, it can be difficult to compare the execution price of an order with the midpoint of the consolidated BBO immediately after the execution of that order, as the order itself may have caused the market to move away from the BBO (which could give an erroneous impression that the order received price improvement). While there is no obviously "correct" timeframe that should be applied, we believe that 30 minutes is too long to judge the execution quality of orders of securities that trade in high volume and would suggest instead a five-minute period.

Second, as noted above, the information required under the rule would be categorized by order size. The term "categorized by order size" is defined in the proposed rule as dividing orders into separate categories for sizes from 100 to 499 shares, from 500 to 1999 shares, from 2000 to 4999 shares, and 5000 or greater shares. We believe that large orders should not be categorized by aggregating all orders of over 5000 shares into one category. Most institutional orders are well over 5000 shares. Therefore, we recommend that the Commission establish several more categories, such as from 5000 to 9999 shares, from 10,000 to 19,999 shares, from 20,000 to 29,999 shares, from 30,000 to 39,999 shares, from 40,000 to 49,999 shares, and 50,000 or greater shares.[6]

Finally, we recommend that the rule also require disclosure by market centers about any system outage that prevented or materially delayed the execution of trades during the reporting period. This disclosure should include the duration of and reason for the outage, and the steps taken to prevent future outages. This is important information for evaluating the quality of order execution.

3. Procedures for Making Reports Available to the Public

The proposed rules would provide that the monthly order execution reports be made available by market centers in electronic form rather than in writing and directs the SROs to act jointly in establishing procedures for market centers to follow in making their monthly reports available to the public in a readily accessible, uniform, and usable electronic format. The Proposing Release states that the Commission anticipates that the SROs would prepare and submit a joint plan to the Commission for approval and that the plan would be proposed for public comment prior to Commission approval.

The Institute strongly supports providing the proposed information in electronic form to facilitate the public's use of the information. In addition, given technological advances in the dissemination of information and the wide use of the Internet by retail investors, we believe that the reports can be made available to the public in a reasonably efficient manner at a low cost.

It is unclear, however, from the Proposing Release what the timeframe will be for SROs to prepare and submit a joint plan to the Commission on establishing procedures for market centers. In view of the importance of the market center reports, the Commission should set a firm deadline by which SROs must submit a joint plan.

B. Proposed Rule 11Ac1-6—Disclosure ofBroker-Dealer Order Routing Practices

Proposed Rule 11Ac1-6 would require disclosure of the order routing practices of broker-dealers that route orders as agent on behalf of their customers. The proposed rule would require broker-dealers to disclose, among other things, the venues to which they routed customer orders, the significant objectives that the broker-dealer considered in determining where to route orders, and the results actually achieved compared with the result available at other venues.

The Institute strongly supports the required disclosure of the order routing practices of broker-dealers. Our members report that information in this area is difficult, if not impossible, to gather. Information on the order routing practices of broker-dealers, including payment for order flow arrangements and internalization agreements entered into by many broker-dealers, would help investors understand what actually happens to their order when it is given to a particular broker-dealer. In addition, requiring broker-dealers to discuss and analyze their order routing practices may encourage broker-dealers to consider opportunities for price improvement.[7] We recommend the following changes to the proposed rule to improve its effectiveness.

First, under the proposal, the term "customer order" would be defined as any order to buy or sell a covered security that is not for the account of a broker-dealer, but would exclude any order for a quantity of a security having a market value of at least $200,000 for any covered security other than a security that is an option contract. The Proposing Release states that large orders are excluded in recognition of the fact that statistics for where orders are routed and general descriptions of order routing practices are more useful for smaller orders that tend to be homogenous. While this may be true, the Institute believes that information on all orders would be important and useful and recommend that the Commission not place a limit on the scope of "customer order" under the rule.

In addition, we believe that the rule should encompass orders for securities not covered by the proposed rule as drafted, such as those quoted on the OTC Bulletin Board or otherwise in the over-the-counter market. Further, there should not be any exclusions from the rule for broker-dealers that route a relatively small number of orders on behalf of customers. There does not appear to be a compelling policy reason to exclude such securities or broker-dealers. We are not convinced that the cost would be so burdensome as to outweigh the benefits of providing useful order routing information.

C. Trade-Through Disclosure Rule

In order to strengthen price priority across markets, the Commission is considering a trade-through disclosure rule for the equities markets similar to the proposed approach for the options markets.[8] Under that approach, a broker-dealer would have to disclose to its customer when the customer’s order traded at a price that is worse than the best quote published. As stated above, the Institute supports increased disclosure to investors regarding execution quality. Information on trade-throughs would provide useful information to investors.

As the Proposing Release states, a trade-through disclosure requirement in the equity markets could give a strong incentive to market centers to develop effective access to other market centers participating in the quote, without the Commission mandating a particular form of linkage. This could help ensure that the best quote interacts with orders across the markets by discouraging broker-dealers from routinely executing customer orders at inferior price levels. It also could help protect customer orders from unintended executions at inferior prices.

The Institute recommends that the Commission incorporate any trade-through disclosure rule into the proposed required disclosures by market centers and broker-dealers so that all investors can gather and evaluate this information. This will provide valuable information to investors on the execution quality of market centers. For example, in the reports filed by market centers, there could be disclosure of the number of times that a market center traded-through during the period.

* * *

The Institute appreciates the opportunity to comment on these disclosure rule proposals. Any questions regarding our comments may be directed to the undersigned at

202-326-5815 or to Ari Burstein at 202-371-5408.

Sincerely,

Craig S. Tyle
General Counsel

cc: Annette L. Nazareth, Director
Robert L. D. Colby, Deputy Director
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ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,034 open-end investment companies ("mutual funds"), 496 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.024 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

2 Securities Exchange Act Release No. 43084 (July 28, 2000), 65 FR 48406 (August 8, 2000) ("Proposing Release").

3 Securities Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10577 (February 28, 2000) ("Concept Release").

4 Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated May 12, 2000.

5 We recommend that the Commission clarify in its release adopting the proposed rule that a market center may provide information in addition to that required by the rule, if it so chooses. It would be beneficial to investors and the marketplace if the rule were to serve as a "floor" rather than a "ceiling" as to the information provided by market centers.

6 We would oppose categorizing large orders in an amount in excess of 50,000 shares because of our concern that the identity of large institutional investors who often trade in share amounts greater than 50,000 (of which there is a relatively small universe) could be determined.

7 We also support the proposed requirement that broker-dealers, upon request of a customer, disclose to the customer the identity of the venue to which the customer's orders were routed for execution in the six months prior to the request, whether the orders were directed orders or non-directed orders, and the time of the transactions, if any, that resulted from such orders.

8 Securities Exchange Act Release No. 43085 (July 28, 2000).

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