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March 17, 2003

Dr. Alexander Schaub  
Director General  
Internal Market of Directorate General  
Rue de la Loi 200  
B-1049 Brussels  
Belgium

**Re: Proposed Revision of the Investment Services Directive**

Dear Dr. Schaub:

The Securities Industry Association<sup>1</sup> is submitting this comment letter in response to the revisions to the Investment Services Directive ("ISD")<sup>2</sup> proposed by the European Commission ("Commission"). We believe that a continued open and transparent consultation process as this legislation is finalized and implemented will facilitate the development of an appropriate legal and regulatory framework for the European securities markets of the 21<sup>st</sup> century. We therefore welcome the opportunity to comment on the Commission's 19<sup>th</sup> November 2002 proposal to revise the ISD ("2ISD Proposal"). While the firms represented by SIA have many comments on the 2ISD Proposal, this letter specifically addresses certain concerns raised by Article 25 of the Proposal.

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<sup>1</sup> The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. Collectively they employ more than 495,000 individuals, representing 97 percent of total employment in securities brokers and dealers. The U.S. securities industry manages the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2001, the industry generated \$280 billion in U.S. revenue and \$383 billion in global revenues.

<sup>2</sup> Directive 93/22/EEC.

## **I. Introduction**

We strongly believe that a more integrated European capital market will benefit European consumers, investors, and companies. An integrated market will improve capital allocation, reduce intermediation costs (thus maximizing the savings that is channeled to investment), and make the EU a more attractive environment for capital. It is on this basis that SIA is pleased to comment on the revised ISD.

SIA supports the Commission's efforts to revise the ISD to reflect new developments in the European securities markets and, in particular, to eliminate obstacles resulting from the current ISD's now outdated approach to the regulation of market structure. Competition and choice should be the principal determinants of an efficient market. As the Commission itself has recognized, Member State rules that require all retail equity trades to be executed on the local regulated market (so-called "concentration rules") prevent investors from selecting the market that best fits their needs, hinder the development of new and innovative trading mechanisms, and do not necessarily result in better prices for investors.<sup>3</sup> We commend the Commission for its decision not to renew the concentration rule option in the current ISD.

The Commission, Member State securities regulators and market participants, however, continue to struggle with an appropriate new framework for competition between regulated markets, multilateral trading facilities ("MTFs"), and investment firms. SIA agrees with the Commission that the "over-arching regulatory objectives" for ISD revision should be "investor protection, market efficiency and the creation of a single financial market..."<sup>4</sup> Nevertheless, we are concerned that, in the area of market structure regulation, the Commission has proposed legislative measures that are inconsistent with its stated objectives. Specifically, Article 25 of the 2ISD Proposal ("Obligation for investment firms to make public firm bid and offers"), in its

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<sup>3</sup> Proposal for a Directive of the European Parliament and of the Council, On Investment Services and Regulated Markets – Explanatory Memorandum (19<sup>th</sup> November 2002) ("Explanatory Memorandum") at Section II.1. In addition, the current ISD's optional approach to market structure regulation has given rise to "fundamental divergencies" in order execution methodologies between Member States. *Id.* at Section I.3.

<sup>4</sup> Revision of Investment Services Directive (93/22/EEC): Second Consultation, Overview Paper – Executive Summary.

current form, would restrict investor choice, reduce competition and liquidity, and roll back the progress that has been made towards a single integrated European securities market.

## **II. Proposed Article 25 Will Have the Effect of Concentrating Retail Trades on Regulated Markets**

The Commission asserts that the proposed pre-trade transparency requirements would enhance "[t]he overall price formation process and the effective enforcement of 'best execution'" by making information about current trading opportunities "immediately and easily visible" to other market participants.<sup>5</sup> Article 25(1) of the 2ISD Proposal would require "any investment firm authorised to deal on [its] own account" to "make public a firm bid and offer price for transactions of a size customarily undertaken by a retail investor in respect of shares in which it is dealing..."<sup>6</sup> and to trade with other investment firms and eligible counterparties "at the advertised prices."<sup>7</sup>

Similarly, under Article 20(4), investment firms would be required to "make public immediately... in a manner which is easily accessible to other market participants" the terms of "a client limit order which cannot be immediately executed under prevailing market conditions." The only way that brokers will be able to comply with Article 20(4), specifically the requirement that the terms of covered limit orders be made public "in a manner which is easily accessible to other market participants," is to place those orders on an exchange limit order book. In the United States, customer limit orders generally are only required to be displayed if they are retail-sized non-discretionary orders and they either are at a better price than the market maker or specialist's quote or are priced equal to the market maker or specialist's quote when that quote is

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<sup>5</sup> Explanatory Memorandum at Section II.5.b.

<sup>6</sup> Under Article 25(2) of the 2ISD Proposal, the mandatory quotation obligation would be waived for dealers that do not represent "an important provider of liquidity for the share(s) in question on a regular or continuous basis." The definition of "important provider of liquidity," like the definition of many of the other key terms in Article 25, would be left to Level 2 measures.

<sup>7</sup> A dealer would not be required to trade at its advertised prices "where justified by legitimate commercial considerations related to the final settlement of the transaction." It is not clear what the phrase "related to the final settlement of the transactions" means or why the Commission believes that such a restriction is justified. As discussed below, this aspect of proposed Article 25 will have significant implications for the individual dealer's counterparty exposure as well as for systemic risk.

the national best bid or offer and the limit order would represent a more than de minimis change in the displayed depth. Discretionary limit orders and large sized block orders are not required to be displayed.<sup>8</sup>

These provisions are based, in part, on rules adopted by the U.S. Securities and Exchange Commission ("U.S. SEC"), specifically Rule 11Ac1-1 ("U.S. Firm Quote Rule"),<sup>9</sup> and the National Association of Securities Dealers, Inc. ("NASD"). However, in selectively borrowing certain elements of U.S. securities regulation, the Commission has overlooked significant differences between the U.S. and European securities markets. One fundamental difference is that unlike in the U.S., European markets are primarily order-driven. As a result, the imposition of a quotation requirement in such an environment will distort the European market. Moreover, as described in more detail below, Europe lacks the infrastructure necessary to support a mandatory quotation obligation in the form proposed by the Commission. Instead of enhancing the price formation process and overall market efficiency, as the Commission claims, the 2ISD Proposal will establish a strong regulatory bias in favor of execution on regulated markets.

*A. Given Europe's Current Infrastructure, Proposed Article 25 Would Not Produce The Anticipated Benefits for Investors*

As we understand the Commission's position, dealers would be able to comply with Article 25's mandatory quotation obligation by posting bids and offers on their websites or by giving the data to a third-party service, such as Bloomberg or Reuters. We agree with the Commission that market forces should be allowed to determine the most efficient means of reporting and consolidating quotation data.<sup>10</sup> Nevertheless, we are concerned that Article 25, in

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<sup>8</sup> For example, the customer may request that the investment firm give protection on the overall transaction value, such as a limit on total costs, but the price and time of execution of the individual transactions that comprise the order are determined by the firm according to market conditions and the customer's goals. The US SEC recognizes that most institutional investors would prefer not to have their orders displayed in order to avoid having the market moving against them.

<sup>9</sup> 17 CFR 240.11Ac1-1.

<sup>10</sup> See, e.g., Revision of Investment Services Directive (93/22/EEC): Second Consultation, Overview Paper at Section 2 ("The revised orientations do not advocate any top-down or regulatory-led intervention in respect of data consolidation. Instead, the assumption is that independent data consolidators/vendors or other entities will provide commercial solutions to the issue of data consolidation" in Europe).

its current form, is unworkable and will have an adverse effect on the quality of executions received by customers.

We believe that the Commission has not given sufficient consideration to the diverse and decentralized nature of the European securities markets and the interaction between Article 25 and other provisions of the 2ISD Proposal. Specifically, under proposed Article 19 (“Obligation to execute orders on terms most favourable to the client”), investment firms would be required to “ensure” that customers obtain “the best possible result.”<sup>11</sup> This provision could be read to require a broker to consult every execution venue “to which the investment firm reasonably can be expected to have access.” There currently is no efficient means for a broker to gather and compare quotes from all of the various regulated markets, MTFs and dealers that trade a security, and Article 25 would substantially increase the volume of price information and the number of distribution channels. Accordingly, brokers could have to check many websites and system screens to determine which execution venue has the most favorable terms. During the time it takes to conduct such a search, there is a significant risk that quotes will become stale and the market will move against the customer.<sup>12</sup> In addition, it is not clear how brokers would access

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<sup>11</sup> Article 19(1) of the 2ISD Proposal would require that investment firms that directly or indirectly execute customer orders “ensure that those orders are executed in such a way that the client obtains the best possible result in terms of price, costs, speed and likelihood of execution, taking into account the time, size and nature of customer orders, and any specific instructions from the client.” We are troubled by the use of the term “ensure,” which suggests that a broker can guarantee the “best possible result” on a trade-by-trade basis. Article 19(1) should be revised to clarify that a broker’s obligation is to seek to obtain best execution and that routing decisions for retail orders can be made on an aggregate basis.

These suggested revisions would be consistent with the U.S. approach. As formulated by the U.S. SEC, the duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for the execution of a customer’s transaction. *See, e.g.,* Securities Exchange Act Release No. 37619A (Sept. 6, 1996) (File No. S7-30-95) at Section III.C.2. Best execution in the United States is a fluid concept that “... evolve[s] as changes occur in the market that give rise to improved executions for customer orders.” *Id.* Following the development of automated order routing systems, the U.S. SEC recognized that “it could be impractical, both in terms of time and expense, for a broker that handled a large volume of orders to determine individually where to route each order it received. [The U.S. SEC] therefore stated that broker-dealers routing orders for automated execution could satisfy their best execution obligation by assessing periodically the quality of competing markets to assure that aggregated order flow was directed to markets providing the most advantageous terms for their customers’ orders.” Securities Exchange Act Release No. 36310 (Sept. 29, 1995) (File No. S7-30-95) at Section I.B. As this suggests, the U.S. SEC views best execution as a process, not a guarantee of a particular outcome. A broker-dealer satisfies its duty of best execution by regularly and rigorously reviewing its internal order handling practices.

<sup>12</sup> These search costs ultimately will be passed through to investors.

the dealer quotes generated by Article 25 given the lack of electronic linkages between and among investment firms. We expect that, especially in Member States with less developed capital markets, many dealer quotes will be accessible only by telephone. This will add further delay that could impact execution quality.

Conversely, it is not clear how and on what terms dealers would be required to provide access to their quotes. For example, internet access is not necessarily a viable option in light of timing distortions and the need to protect internal data security and the integrity of quotations. Would a broker-dealer be required to provide a high speed line for competitors to access its quotes? If so, who would be responsible for the cost of such lines? Furthermore, would a broker-dealer be allowed to deny access based on credit concerns? (See further discussion below.)

By way of contrast, the securities markets in the United States are integrated at many levels. This infrastructure includes the consolidated quotation system ("CQS");<sup>13</sup> the consolidated tape;<sup>14</sup> intermarket linkages such as the ITS/CAES interface;<sup>15</sup> automatic order routing and execution systems offered by broker-dealers, electronic communication networks and exchanges; and a central clearing and settlement system. The development of the current U.S. market structure began with the Securities Exchange Act Amendments of 1975,<sup>16</sup> in which Congress directed the U.S. SEC to use its authority under the Securities Exchange Act of 1934 to

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<sup>13</sup> CQS allows investors to view, in a single source, quotes for exchange-listed equity securities that are disseminated by dispersed market centers. CQS collects quotation information from the U.S. securities exchanges and significant over-the-counter ("OTC") market makers that trade a security; determines the national best bid and best offer; and disseminates the information to broker-dealers and information vendors.

<sup>14</sup> The consolidated tape is a high-speed, electronic system that constantly reports the latest price and volume data on sales of exchange-listed equity securities. The data reflected on the consolidated tape derives from various market centers, including securities exchanges, electronic communications networks ("ECNs"), and OTC market makers.

<sup>15</sup> The Intermarket Trading System ("ITS") is an order routing network designed to facilitate intermarket trading in exchange-listed equity securities among U.S. securities exchanges based on current quotation information emanating from their markets. The Computer Assisted Execution System ("CAES") is an automated system regulated by the NASD and operated by NASDAQ that allows NASD members to direct orders in listed securities to CAES for automated execution against quotations of OTC market makers. The exchange and the OTC market for listed securities are linked through the ITS/CAES interface.

<sup>16</sup> Pub. L. No. 94-29, 89 Stat. 97 (1975) ("1975 Amendments").

facilitate the development of a national market system. In the years since 1975, the U.S. regulatory framework has evolved incrementally as the U.S. SEC has gained experience with the national market system.<sup>17</sup> For example, the scope of the U.S. Firm Quote Rule has been expanded in several steps, in response to new execution arrangements, market practices and technology.<sup>18</sup>

In sum, the U.S. SEC rules that serve as the basis for proposed Article 25 are inextricably linked to the information and trading infrastructure in the United States, as that infrastructure has developed over the past twenty-five years, and cannot simply be transplanted into the very different European markets. By attempting to do so, the Commission has designed a regulatory approach that is impractical and, in fact, runs counter to the objectives of ISD revision, which would be better served by a properly formulated and administered best execution standard.

*B. Compliance with the Proposed Article 25 Would Expose Dealers to Significant Increases in Credit Risk*

As noted above, Article 25(1) of the 2ISD Proposal would require that, once an investment firm makes public a firm bid and offer, it must trade with other investment firms and eligible counterparties "at the advertised prices." A dealer could decline to trade with a

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<sup>17</sup> It is worth noting that the 1975 Amendments, which would correspond to Level 1 or Level 2 measures in the European Union, specified the key features of a national market system for securities and directed U.S. SEC to use its authority to facilitate the development of a national market system. The U.S. Firm Quote Rule and other technical requirements have been adopted by the U.S. SEC pursuant to that delegated authority.

<sup>18</sup> The U.S. Firm Quote Rule was adopted in January 1978, more than two years after the enactment of the 1975 Amendments. Securities Exchange Act Release No. 14415 (Jan. 26, 1978) (File No. S7-648). The Consolidated Quotation Plan was adopted later in 1978. Securities Exchange Act Release No. 15009 (July 31, 1978) (File No. 4-281). Initially, the Firm Quote Rule applied to all exchanges and OTC market makers. In 1982, the U.S. SEC limited the scope of the rule in response to vendor capacity problems, stale quotes and other reliability and cost issues. Securities Exchange Act Release No. 18482 (Feb. 11, 1982). As revised in 1982 and again in 1996, the only market participants subject to a *mandatory* quotation obligation currently are exchanges and OTC makers that account for more than 1% of the aggregate trading volume in a security. Rule 11Ac1-1(a)(25)(i)(A) and (ii)(A). In 1996, the U.S. SEC amended the U.S. Firm Quote Rule to incorporate into the consolidated quote stream orders placed by exchange specialists and OTC market makers in ECNs at prices better than their displayed bid/offer. Securities Exchange Act Release No. 37619A (Sept. 6, 1996). Finally, in response to the development and growing use of alternative trading systems (*i.e.*, MTFs), the U.S. SEC adopted Regulation ATS in 1998. That regulation, among other things, requires an alternative trading system with 5% or more of trading volume in a covered security to publicly disseminate its best priced orders. Rule 301(b)(3). *See also* Securities Exchange Act Release No. 40760 (Dec. 8, 1998) (File No. S7-12-98).

particular counterparty only to the extent "... justified by legitimate commercial considerations related to the final settlement of the transaction." Under a literal reading of that language, Article 25(1) could require an investment firm to deal with a counterparty regardless of whether they have a pre-existing business relationship or whether the counterparty or transaction complies with the dealer's credit risk guidelines. Such an interpretation would expose dealers to excessive counterparty risk, thereby reducing their willingness to provide liquidity away from regulated markets. It is by no means clear that the phrase "related to the final settlement of the transaction" would address the critical credit concerns necessary for managing a global securities firm.

Moreover, we understand that the Commission may interpret the phrase "at the advertised prices" in Article 25(1) to prohibit dealers from trading at prices that are better than their displayed quotations. This effectively would prevent dealers from providing price improvement to customers. If the Commission in fact intends to take such an approach, Article 25(1) would represent a significant departure from the U.S. Firm Quote Rule, which requires OTC market makers to trade at a price at least as favorable as their published bid/offer in any amount up to their published quotation size.<sup>19</sup> It also would be inconsistent with customary market practice in the U.S. and European securities markets that large trades take place at a premium or discount.

The Commission cites the U.S. experience (specifically the example of the NASD's Small Order Execution System or "SOES") as proof that mandatory quotation obligations do not impede liquidity provision for retail-size transactions in highly liquid securities.<sup>20</sup> We believe that, by overlooking the significant differences between the U.S. and European securities markets, the Commission has vastly underestimated the effect of its proposals on dealers' willingness to provide liquidity support.

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<sup>19</sup> See Rule 11Ac1-1(c)(2), 17 CFR 240.11Ac1-1(c)(2). See also Rule 11Ac1-1(c)(3), 17 CFR 240.11Ac1-1(c)(3) (specifying situations in which an OTC market maker is not obligated to honor its prior quote).

<sup>20</sup> Explanatory Memorandum at Section II.5.b. See, *infra*, note [24] for more information about SOES.

First, in Europe, there generally is no central counterparty that interposes itself between buyers and sellers of equity securities in the OTC market. Because buyer and seller deal with each other bilaterally, firms are directly exposed to the creditworthiness of their counterparty. Dealers therefore have established internal systems and controls designed to ensure that their counterparty does not pose an unacceptable credit risk. To the extent Article 25 obligates a dealer to trade with *any* investment firm or eligible counterparty, the dealer will be forced to rely solely on the counterparty's compliance with minimum regulatory capital requirements. In contrast, in the United States, virtually all equity transactions clear and settle through the National Securities Clearing Corporation ("NSCC"), which guarantees completion of compared trades and nets deliveries and payments among its participants. This limits the degree of credit risk faced by each participant, as well as systemic risk throughout the U.S. securities markets.

Moreover, the Commission does not appear to have given adequate consideration to the aggregate credit exposure that could result from a large number of small transactions. Article 25(1) would require an investment firm to quote and deal "in a size customarily undertaken by a retail investor." It is not clear on the face of the proposal how dealers would indicate the size associated with their best price or how they could limit additional exposure once that size is exhausted. In the United States, an OTC market maker must provide both price and size to the NASD for submission to CQS;<sup>21</sup> an OTC market maker is required to trade at a price at least as favorable as its published bid/offer *in any amount up to its published quotation size*.<sup>22</sup> A market maker, however, is not required to execute an order at its prior quote if the order is received after the market maker has submitted a revised size and/or price to CQS or while the market maker is in the process of executing a transaction provided that, immediately after completion thereof, the market maker submits a revised size and/or price to CQS.<sup>23</sup> Even with these types of safeguards, certain market participants have been able to hit a dealer's quote repeatedly and to

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<sup>21</sup> See paragraph (c)(1) of Rule 11Ac1-1, 17 CFR 240.11Ac1-1(c)(1).

<sup>22</sup> See paragraph (c)(2) of Rule 11Ac1-1, 17 CFR 240.11Ac1-1(c)(2).

<sup>23</sup> See paragraph (c)(3) of Rule 11Ac1-1, 17 CFR 240.11Ac1-1(c)(3).

trade in size that exceeds the depth that the dealer had displayed.<sup>24</sup> The risks of such conduct will be even greater under the 2ISD Proposal, which includes far fewer safeguards.

*C. The 2ISD Proposal Would Give Regulated Markets a De Facto Monopoly*

The requirements imposed by Articles 25, together with other provisions of the 2ISD Proposal,<sup>25</sup> will establish a systematic bias against off-exchange execution. The 2ISD Proposal changes the cost-benefit analysis for both brokers and dealers in a manner that strongly favors the regulated markets. Given the progress that has been made towards the development of an open and competitive system, we believe that it would be a step *backwards* to allow the regulated markets to have a de facto monopoly.

On the one hand, the lack of consolidated price data and intermarket linkages, combined with the Commission's results-oriented approach to best execution and the default rule, will create a significant incentive for brokers to route customer orders to the local market for execution. On the other hand, given the potential credit risk associated with the obligation to

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<sup>24</sup> While SOES no longer exists (it has been replaced by the new SuperMontage platform for trading NASDAQ securities), the history of SOES suggests that the U.S. experience with mandatory quotation obligations has not been uniformly favorable. The NASD established SOES to provide automatic execution of small retail orders against NASDAQ market makers. According to an August 1998 report issued by the U.S. General Accounting Office, however, the primary users of SOES were day trading firms. These firms typically entered orders for the maximum allowable transaction size, traded frequently throughout the trading day, and ended the day flat (*i.e.*, position-neutral). *Securities Market Operations: The Effects of SOES on the Nasdaq Market* (GAO/GGD-98-194, Aug. 1998). According to the report, "Day traders' software systems have enabled them to take advantage of their immediate, automatic access to SOES by entering as many trades as they wanted, quickly cancel orders or enter multiple orders with an individual keystroke, and be notified about securities that reached predetermined prices." *Id.* at p.9. The market makers interviewed by GAO contended that, due to SOES day trader activity and the resulting increase in costs, market makers "have reduced the number of stocks in which they make markets," "are putting up less capital in total than formerly," and "are offering to buy or sell smaller amounts of the stocks in which they make a market." *Id.* at p.15. While the report did not reach any definitive conclusions about the effects of SOES on liquidity provision, it clearly indicates that mandatory participation in SOES had unintended consequences for market maker liability.

<sup>25</sup> For example, Section 20(3) of the 2ISD Proposal would require that "investment firms obtain the express prior consent of clients before proceeding to execute client orders outside the rules and systems operated by a regulated market or MTF." While trade-by-trade consent would not be required, any generalized (*i.e.*, blanket) consent would have to be renewed annually. There is no comparable requirement under U.S. securities regulation.

deal, we fear that dealers will widen their spreads and/or reduce the amount of capital that they are willing to commit to the market.

The net result of Article 25's requirements will be to diminish investor choice. Market participants will be deprived of desired services, specifically those that regulated markets cannot supply (*e.g.*, commitment of capital to orders that are larger than normal trade size but not large enough for the regulated markets' "iceberg" facilities; program trading; and simultaneous execution of cash and derivatives transactions). In addition, by reducing competition, these proposals will diminish the incentives to develop innovative trading mechanisms and to reduce trading costs. This is wholly inconsistent with one of the Commission's guiding principles with respect to market structure regulation: "ISD revision should not prohibit or otherwise impede, through application of unjustified or inappropriate regulatory requirements, order-execution outside traditional marketplaces/exchanges."<sup>26</sup>

### **III. Proposed Article 25 Will Have a Negative Impact on Liquidity in Wholesale Markets**

In addition to undoing the benefits of eliminating concentration rules for retail equity trades, the proposed requirements will have a negative impact on wholesale markets as well. Article 25(1) would impose a mandatory quotation obligation on "any investment firm authorised to deal on own account." This obligation would cover many more firms than the U.S. Firm Quote Rule, which, as relevant here, only applies to dealers that are OTC market makers.<sup>27</sup> To be an "OTC market maker," a dealer must "*hold[] itself out* as being willing to buy from or and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on an exchange *in amounts of less than block size*"

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<sup>26</sup> Explanatory Memorandum at p.13.

<sup>27</sup> The U.S. Firm Quote Rule requires a dealer to publish quotations in any "subject security." With respect to bids and offers communicated otherwise than on an exchange, the term "subject security" means an exchange-traded security for which such dealer "*acts in the capacity of an OTC market maker* unless the executed volume of such [dealer], during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system" (emphasis added). See paragraph (a)(25)(ii)(A) of Rule 11Ac1-1, 17 CFR 240.11Ac1-1(a)(25)(ii)(A). Note that the NASD also imposes firm quote requirements on OTC market makers in listed stocks, see NASD Rule 6330, and on NASDAQ market makers, see NASD Rule 4613.

(emphasis added).<sup>28</sup> Block size is generally considered to be an order of at least 10,000 shares or for a quantity of stock having a market value of at least U.S. \$200,000.

Although Article 25 of the 2ISD Proposal contains a narrow exemption for "small" dealers, presumably based on total share or euro volume,<sup>29</sup> the Commission has not distinguished between dealers that run a retail market making operation and other firms that are active traders for their own account, including dealers that engage primarily in the facilitation of large orders for institutional customers. As the U.S. SEC has recognized with respect to those dealers that act as block positioners:

Block positioners usually do not maintain prices at which they are willing to buy and sell a particular security; rather, they make known their role of assisting in the purchase and sale of large positions in securities at some price. Consequently, these dealers do not function as typical dealers that maintain a regular or continuous price quote. The Commission has concluded that requiring quotations from these dealers would not provide useful price information and therefore a dealer that acts solely as a block positioner should remain excluded from the definition [of OTC market maker].<sup>30</sup>

In effect, the proposed requirements will turn institutional trading firms into retail market makers, without regard to whether they have any interest in doing retail business or whether the prices for large transactions (which typically are negotiated with the dealer on a trade-by-trade basis and may reflect a liquidity premium) embody useful information about potential trading opportunities for retail investors. To the extent that Article 25's mandatory quotation obligation reduces their profitability, dealers will become less willing to provide liquidity in the wholesale market. Whatever the costs or benefits of off-exchange execution of retail orders, there is no

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<sup>28</sup> See paragraph (a)(13) of Rule 11Ac1-1, 17 CFR 240.11Ac1-1(a)(13).

<sup>29</sup> Article 25 would not apply to a dealer that is not "an important provider of liquidity" in the shares in question. This exemption appears to be based on the "1% Test" incorporated into the U.S. Firm Quote Rule through the definition of "subject security." See, *supra*, note [27].

<sup>30</sup> Securities Exchange Act Release No. 37619A, 1996 WL 506154, \*45 (Sept. 6, 1996).

Dr. Alexander Schaub  
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basis to interfere with existing market practices involving sophisticated institutions that are able to protect their own interests.

#### **IV. Conclusion**

SIA supports the Commission's efforts to revise the ISD to reflect new developments in the European securities markets and, in particular, to eliminate obstacles resulting from the current ISD's now outdated approach to the regulation of market structure, including removal of the concentration rules. We are concerned that, in the area of market structure regulation, the Commission has proposed legislative measures that are inconsistent with its stated objectives.

It is our view that Article 25 of the 2ISD Proposal ("Obligation for investment firms to make public firm bid and offers") will have the effect of concentrating retail trades on regulated markets, and negatively impact on liquidity in the wholesale market. In its current form, Article 25 would restrict investor choice, reduce competition and liquidity, and roll back the progress that has been made towards a single integrated European securities market.

We look forward to continuing to work with the Commission on these critical market structure issues. If you have any questions, or would like to discuss these issues further, please contact me at 212/618-0513, or by e-mail to [dstrongin@sia.com](mailto:dstrongin@sia.com).

Sincerely,

David Strongin  
Vice President and Director,  
International Finance

cc: David Wright