



Securities Industry Association

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May 4, 1998

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: Securities Exchange Act Release No. 34-39718; File No. NASD-98-17

Dear Mr. Katz:

The Trading Committee ("Committee") of the Securities Industry Association ("SIA") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") regarding the National Association of Securities Dealers, Inc.'s ("NASD") proposed Integrated Order Delivery and Execution System (the "System"). The proposed System will provide an automated execution facility that will consolidate the Nasdaq Stock Market's ("Nasdaq") two principal trading systems, *i.e.*, the Small Order Execution System ("SOES") and SelectNet, coupled with a Nasdaq-sponsored voluntary limit order book that will allow NASD members and sponsored participants to enter and display anonymous limit orders without the need for those limit orders to be represented in a market maker's quotation.

The Committee enthusiastically supports the automated delivery and execution features of the System and applauds the NASD for addressing the problems that member firms have experienced in managing multiple points of execution. While the Committee shares the NASD's goal of providing a fair market structure for all investors, we believe that the proposed limit order facility, as described in the filing, has anti-competitive elements that could operate to the detriment of public investors. We are confident, however, that the limit order facility could be designed in a way, as discussed below, that would meet investors' needs and guarantee investor protection while maximizing competition and enhancing liquidity in the Nasdaq market. We strongly urge the SEC and the NASD to consider this alternative.

The NASD's proposed System will enable all registered participants to send orders to access the best market maker quotation, qualified Electronic Communications Network ("ECN") order, or orders entered in the Nasdaq Limit Order Book. Registered NASD members, and certain customers that are sponsored by NASD members, will be able to deliver orders of varying size

through the new System to electronically access the displayed quotations. The NASD states that the System is intended to respond to the demands of investors and NASD members for a marketplace that provides for fast and efficient access to the best prices in the market and effective integration of price discovery, execution, and trade reporting.

The Committee fully supports these goals and believes that recent changes in the Nasdaq market already have largely achieved these objectives. Since implementation of the Commission's order handling rules, customer limit orders can compete with market maker quotations to drive the National Best Bid and Offer ("NBBO"). Subject to very limited exceptions, a dealer must execute an order or change his quotation to reflect a better priced customer limit order, thus assuring investors that the best prices are displayed to the entire market. Additionally, under current NASD rules, a dealer is prohibited from trading ahead of a public limit order that he holds. In fact, if a market maker holds an undisplayed limit order priced better than the quote, and he subsequently receives a market order on the opposite side of the market from the limit order, the market maker must pass along the price improvement of the limit order to the market order. The opportunity for customer orders to match against customer orders, therefore, which Congress, the SEC, and the NASD support, and which public investors demand, already exists. Moreover, market makers' and other intermediaries' bids and offers interact as well. Certainly, a single, automatic execution system, as the NASD proposes, with the ability to execute against ECN as well as market maker quotations will further ensure fast access to those prices.

As contemplated by the Commission, the order handling rules have enhanced competition resulting in narrower spreads and greater transparency of customer limit orders. The Committee believes, however, the NASD proposed limit order facility could greatly reduce, if not eliminate, the vibrant limit order competition that the order handling rules have generated. As discussed in more detail below, the limit order facility, as proposed, automatically gives the NASD--a membership-funded self-regulatory organization ("SRO")--an unfair advantage over its members who also provide limit order services. If market making becomes less profitable because of an unfair advantage enjoyed by the NASD, market makers will exit the business leading to less liquidity and wider spreads in many issues. Many low liquidity stocks and small issuers could be left without market maker sponsorship. While a few of the most active Nasdaq issues undoubtedly can survive, and even thrive, in an order-driven market, this is not the case for most Nasdaq issues. Ultimately, the primary function of equity markets capital raising for public corporations could be impeded, and, in times of market stress, there could be an insufficient number of market participants with affirmative obligations to trade in the Nasdaq market to sustain price continuity.

The Committee acknowledges that investors have enjoyed significant savings as a result of the order handling rules but cautions that there is a price to pay for that benefit. There are limits to liquidity. In view of the potential impact of the limit order facility as proposed, the Committee strongly urges the Commission and the NASD to consider the SIA alternative that has been advanced by the Trading Committee, which involves market maker participation in the limit order facility. Combined with a market-wide trade through rule, as discussed below, the Committee believes this approach promotes investor protection, encourages capital formation, and facilitates fair competition within the existing competing dealer market structure.

Background

Since 1996 the Trading Committee has helped shape, review, implement, and monitor the many proposed market structure changes. In commenting on the proposed order handling rules, the NASD's proposed NAcqess System, and various other changes, the Committee has consistently supported change that promotes transparency, competition, and investor protection while resisting any efforts to dilute the competitive essence of the Nasdaq dealer market. With the adoption of the SEC order handling rules in 1997, the Nasdaq market has taken on many characteristics of an auction market. Although auction market principles may be appropriate for deep and liquid stocks, competing dealers are critical in those issues where no natural liquidity exists.

The competing dealer structure of the Nasdaq Stock Market provides substantial benefits to issuers and investors. Nasdaq electronically links dealers and ECNs around the country in over 5,000 issues by automating the display of dealer and ECN quotations. Originally designed as a market of competing dealers in thinly traded over the counter securities, it has been an extremely successful model, providing strong support for small issuers at an important stage in their growth. Market makers are a key component of Nasdaq's strength, risking capital and providing liquidity in times of market stress. A testament to the success of the Nasdaq market is that it now trades over 600 million shares per day and includes such widely-held, actively-traded issues as Intel, Microsoft, and Cisco Systems. Without the support and commitment of market makers, the Nasdaq market could never have achieved such growth. Moreover, without the support and commitment of market makers, companies such as these may never have achieved such growth.

Technological developments over the last several years have accelerated this growth and led to better services, greater efficiency, and more competition among market participants. The NASD and Nasdaq market makers have been at the forefront of the technology revolution, capitalizing on new technologies to constantly enhance the quality of the market and increase the services that they provide. Market makers also have invested significant resources in the development of proprietary automated systems for executing customer orders. These systems add liquidity to the market, increase efficiencies, and offer immediacy of execution. In addition, the demands of different types of investors have given rise to innovative trading systems that directly compete with the exchange and Nasdaq markets. Consequently, there is an ever-increasing array of markets and dealers through which to trade securities.

The Committee supports the efforts of the NASD to remain viable in the face of a changing market structure but believes the appropriate response should be one that provides a level playing field and encourages rather than reduces competition among the various providers of limit order services. The NASD System should include, not exclude, those market participants that have made Nasdaq one of the most innovative and successful markets in the world. Instead of competing with its members, whose dues and fees have funded the technological expansion of the Nasdaq market, the NASD should partner with its members to design an integrated system that increases competition, enhances market liquidity, and reduces transaction costs.

In designing the market for the next Millenium, we must be careful to balance the diverse needs of **all** market participantsissuers, retail and institutional investors, and market professionals, including market makers who provide liquidity. The Committee believes, however, that the limit

order model the NASD has constructed will create a technological monopoly that would stifle competition in the Nasdaq market.

The Proposed Limit Order Facility Will Stifle Competition

As proposed, the NASD System will permit directed and non-directed orders to access market maker, ECN, and UTP exchange specialist quotations and orders in the limit order facility. Directed orders will not interact with orders in the limit order facility or with other market maker quotations displayed in the Nasdaq montage. Directed orders will be processed in time sequence with non-directed orders. Non-directed orders, on the other hand, will interact with the best quotes in the Nasdaq montage in price/time sequence. Non-directed orders that match against an order in the limit order facility will be executed immediately. Non-directed orders delivered to a market maker or an ECN, depending on the size of the order, will be executed immediately (up to the displayed quote size) if the order is for 1,000 shares or less, or executed after a delay of 17 seconds for orders greater than 1,000 shares but less than 5,000 shares, or 32 seconds for orders of 5,000 shares or more. This letter assumes, and the positions stated herein are contingent upon, SEC approval of the NASD proposal to allow market makers to quote their actual size rather than an artificial minimum quotation size for all Nasdaq National Market ("NNM") securities. The SIA Trading Committee strongly supports this proposal.

Although certain features of the proposed System will serve to enhance competition in the Nasdaq market, the Committee believes the proposed limit order facility, as designed by the NASD, will stifle competition. The ability for all market participants to access a single automatic execution system on the same terms will level the playing field and eliminate advantages previously enjoyed by professional day traders. The NASD proposed limit order facility, on the other hand, will create a de facto monopoly for the NASD. Although it is characterized as being a voluntary option for the display of customer limit orders, we believe the effect of the proposed rules will be to drive all orders toward this one mechanism where trades will be executed. The Nasdaq limit order facility will discourage the development and inhibit the continued use of competing limit order systems, or may cause other market participants to abandon them altogether. Without competing technologies, the entire market will become dependent on the capacity and integrity of a single system.

The NASD proposed limit order facility will have several distinct competitive advantages over other market participants. The Nasdaq limit order facility will accept, display, and execute limit orders at any price level. In contrast, market makers and ECNs are able to display only one price level, *i.e.*, one bid and one offer, and have to update their quotation after execution to get the next level of interest displayed and available for execution. The ability of the Nasdaq limit order facility to hold and display several levels of interest will almost always result in the limit order facility having time priority, which could result in poorer executions for customer limit orders held outside the Nasdaq limit order facility.

Also, the ability to expose several levels of bids and offers to the market enables the limit order facility to participate in large or "rapid fire" market orders. For example, suppose there are two market makers in a security, market maker #1 and #2, both bidding for 1,000 shares at 10. Each of the market makers also holds customer buy orders for 1,000 shares at 9 7/8. The limit order facility holds a limit order to buy 1,000 shares at 9 3/4. Three market orders to sell 1,000

shares are entered into the System. Market maker #1 is executed against and is decremented to 0. Market maker #2 is executed against and is decremented to 0. The remaining 1,000 share market order will execute versus the $9 \frac{3}{4}$ buy limit order in the limit order facility before the market makers can update their quotations to display their $9 \frac{7}{8}$ bids.

Although members will not be required to protect orders in their own limit order files beyond their best execution obligation, as a practical matter, in order to compete for limit orders, market makers will have to provide customers with price protection at a specific price equivalent to that which the limit order may have received in the Nasdaq limit order facility. Market makers will be required, for competitive reasons, to execute limit orders in response to a depletion of interest in the Nasdaq limit order facility, which may not reflect actual supply and demand in the marketplace. These orders will be executed out of competitive necessity even though the market maker has not effected any purchases or sales at that price. Because of this, market makers will have less incentive for handling limit orders outside of the Nasdaq limit order facility. Indeed, because of the advantage the System has of always being first in time, best execution obligations may actually **require** market makers to direct their customer limit orders to the Nasdaq limit order facility. Thus, an SRO monopoly of limit order services is assured.

In addition, subsequent to filing this proposal with the Commission, the NASD announced an agreement in principle between the Nasdaq Stock Market and OptiMark Technologies, Inc. that would directly link the proposed Nasdaq limit order facility with the OptiMark technology. The OptiMark technology will allow investors, instead of entering orders at only one price and size, to indicate, across a range of prices and sizes, their willingness to trade. Because OptiMark executions will provide trade-through protection to all limit orders residing in the Nasdaq limit order facility and other displayed interest, multiple price levels for limit order protection can be achieved for orders entered into the Nasdaq limit order facility. However, market makers and ECNs are only guaranteed protection through OptiMark at their displayed price level. Market makers who want to compete with the Nasdaq limit order facility would have to offer equivalent assurances but could not achieve the same protection for multiple price levels without passing their limit order file to the Nasdaq facility.

Finally, most broker-dealer and vendor routing systems are unable to distinguish immediately marketable limit orders from non-marketable limit orders. Consequently, they are likely to choose one destination for all orders. If one destination also happens to be the market regulator, there may be a strong incentive for choosing that facility in the expectation that it will provide a regulatory safe harbor for compliance with best execution and other regulatory obligations.

The Committee believes it is inappropriate for an SRO to operate a System that will compete with its members for order flow, and that is not commercially viable without the regulatory power and position of the SRO. Membership dues and fees have funded the development of the Nasdaq market and, over the years, members have spent millions of dollars building and upgrading their own proprietary systems that have kept the Nasdaq Stock Market on the cutting edge. It is disturbing that the NASD proposes to build, operate, and maintain a System that, in its current design, will undermine the competitiveness of those proprietary systems. In addition, in light of the NASD's equity interest in the OptiMark technology, there is a troubling incentive for the NASD to use its position as regulator to gain an advantage over its member-competitors.

The Committee firmly believes that competition generates best prices and improves the efficiency and quality of the market. A comprehensive system that will attract a significant amount of order flow operated by the NASD is inconsistent with the intent of Congress to allow innovation and competitive forces to shape the National Market System. Although the Nasdaq limit order facility may appear to offer certain advantages today, it will almost certainly destroy any incentive for future innovations in the handling of limit orders. The SEC should ensure that the Nasdaq limit order facility is only one of many sources of quotations in the Nasdaq market.

SIA Trading Committee Alternative

As noted above, the Trading Committee proposes an alternative that satisfies the NASD's objectives, fulfills the needs of investors, and, at the same time, features market maker participation in a positive way. Indeed, we believe the Trading Committee alternative is superior to the proposed System in that it establishes a limit order facility that will encourage broader participation by market makers adding even more depth and liquidity to the Nasdaq market.

The SIA alternative would provide NASD members and sponsored participants the ability to enter directed and non-directed limit orders to buy and sell Nasdaq securities. Non-directed orders would be routed to Nasdaq System market makers in those securities on a rotational basis. Participating market makers would be required to comply with all regulatory obligations including order handling, Manning, and all best execution interpretations. Orders could be entered anonymously, just as in the NASD proposed System. Upon receipt of a non-directed limit order delivered through the Nasdaq System, a market maker active in the rotation would have to accept the order and would have to execute it or represent it in his quotation, with the market maker acting as riskless principal in the same manner as an exchange specialist. Upon execution, the fill would be routed back to the entering participant through the Nasdaq System. If there were no market makers active in the rotation, the order would immediately be included in the Nasdaq limit order facility where the order would reside in its appropriate price/time priority in relation to all other displayed interest.

Under the SIA alternative, all of the functionality of an integrated Nasdaq limit order facility would be available. Order entry participants could rely on Nasdaq to provide anonymity and secure the identity of the party entering the order. Market orders and immediately marketable limit orders would interact with System quotations on a strict price/time priority as described in the filing. The SIA alternative, however, would provide an immediate automatic execution of these orders. Marketable orders of any size would be immediately executed against the quoted size of any market maker or combination of market makers that would satisfy the order. Orders would also immediately execute against the market maker's supplemental or reserve size.

In the NASD proposal, only orders of 1000 shares or less receive automatic executions against market makers. Orders over 1,000 shares can be delayed for as much as 17 seconds and orders over 5,000 shares can be delayed for as much as 32 seconds. The SIA Trading Committee believes the delays are unnecessary and create uncertainty in the market. Thus, investors seeking rapid executions at the best available prices will be advantaged by the system we propose.

If the Commission nonetheless decides to approve the System as proposed notwithstanding our comments, we believe that a trade through rule, as discussed below, must be mandated.

Fairness Dictates a Market-Wide Trade Through Rule

The Committee strongly believes that a market-wide trade through rule should be imposed. Fundamental principles of fairness dictate that no market participant should be allowed to trade through any displayed interest in the Nasdaq market. All orders, whether they are sent to the proposed Nasdaq limit order facility or displayed by market makers in their quotations, should receive equal treatment.

As proposed by the NASD, the System will allow inferior priced trades to be executed in the Nasdaq System without satisfying all better-priced interest displayed in market maker quotations. It is incumbent upon the NASD to insure the integrity of quotations irrespective of whether they reside in the limit order facility or with a market maker. In fact, the NASD proposes to provide trade-through protection through OptiMark for all limit orders residing in the Nasdaq limit order facility and other displayed interest.

Undisplayed orders or supplemental size should not be protected. Market makers, therefore, would have an incentive to display their true trading interest, which will increase transparency in the market. A market-wide trade through rule also would provide incentives for market makers to continue to provide liquidity by enabling market makers to continue to operate their own proprietary execution systems on a more equal footing.

Conclusion

The Trading Committee fully supports market structure changes that promote competition, transparency, accessibility, and fairness for all investors. As proposed, however, the Committee believes the NASD proposed limit order facility will reduce competition, discourage market maker participation in the Nasdaq market, and jeopardize the capital market makers bring to bear in support of the trading of new and smaller capitalized companies in which there may not be sufficient natural liquidity. Having a self-regulator operate a trading system that competes with its regulated members creates irreconcilable conflicts of interest that will ultimately hurt investors.

During the past year, many major changes were introduced in the Nasdaq market including, among other things, new order handling rules, finer increments of trading, and new interpretations with respect to best execution obligations. The benefits to the market are apparent increased transparency and better prices for retail customers. Notably, the changes were implemented at a time when the markets are robust and volume is high. Nevertheless, anecdotal evidence suggests that market makers are widely reducing the number of stocks in which they make a market. Although net market making does not appear to have declined, the support provided for various issues has not been quantified. The true economic impact on market making has been obscured by the continuing bull market, record volume, and general prosperity enjoyed by Wall Street firms. It is doubtful that there would be the same level of commitment if any one of these factors was removed.

We, therefore, urge the Commission to proceed cautiously with initiatives that could provide disincentives for market makers to provide liquidity and to sponsor new issues. The Trading

Committee has proposed an alternative that brings all market participants and investors together in an integrated order delivery and execution system where all orders are processed and distributed in a fair and orderly fashion, and at the same time preserves a competitive dealer market structure. The Committee respectfully requests that the Commission and the NASD consider this alternative.

The SIA thanks the Commission for the opportunity to comment on this major rule proposal. If the Committee can provide additional information, or if you would like to discuss our views further, please contact the undersigned, or Judith Poppalardo, SIA Associate General Counsel, at (202) 296-9410.

Sincerely,

Bernard L. Madoff
Chairman
Trading Committee

cc: The Honorable Arthur Levitt, Chairman, SEC
The Honorable Norman S. Johnson, Commissioner
The Honorable Isaac Hunt, Jr., Commissioner
The Honorable Laura S. Unger, Commissioner
The Honorable Paul Carey, Commissioner
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