



Securities Industry Association

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September 26, 2000

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Securities Exchange Act Release No. 34-43084; File No. S7-16-00

Dear Mr. Katz:

The Market Structure Committee (“Committee”) of the Securities Industry Association¹ appreciates this opportunity to provide comments on Securities Exchange Act Release No. 34-43084, which proposes two new rules designed to improve public disclosure of order routing and execution practices. Under proposed Rule 11Ac1-5, market centers that trade national market system securities, including market-makers and exchange specialists, would be required to make available to the public monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis. Under proposed Rule 11Ac1-6, broker-dealers that route orders in equity and option securities on behalf of customers would be required to make publicly available quarterly reports that describe their order routing practices and disclose the venues to which customer orders are routed for execution. In addition, broker-dealers would be required to disclose to customers, on request, where their individual orders were routed for execution. The Committee strongly supports enhanced disclosure, although certain disclosures in the Commission’s proposal raise concerns as discussed in more detail below.

¹ The Securities Industry Association (“SIA”) brings together the shared interests of nearly 800 securities firms, employing more than 380,000 individuals, to accomplish common goals. SIA members—including investment banks, broker-dealers, and mutual fund companies—are active in all markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans, and accounts for \$270 billion of revenues in the U.S. economy.

Unfortunately, the Committee's comments will necessarily be general in many circumstances despite the Commission's request for comment on specific points throughout the Release. The Release was issued in August, during peak vacation season, with a relatively brief comment period (45 days) in light of the complexity of the proposal. The Commission is reportedly unwilling to extend the comment period and 45 days is simply insufficient time to analyze in detail a major regulatory proposal that apparently took many months to develop.

I. Background

Enhanced disclosure of order routing and execution practices was one of six alternatives presented to address the adverse effects of fragmentation in the Securities and Exchange Commission's ("SEC") Request for Comment on Issues Relating to Market Fragmentation.² Presumably, the Commission is proposing these rules because disclosure is the single approach described in the Release that received widespread support. As stated in this Release, "Of the 44 commenters who discussed this option, 32 commenters supported some form of disclosure by market centers and broker-dealers of factors concerning their trade executions and arrangements for handling orders. Commenters supporting increased disclosure believed that it would allow investors to make informed judgments about where to route their orders, as well as enable brokers to evaluate the quality of executions among market centers and fulfill their duty of best execution."³

While this Committee generally supports enhanced disclosure of order routing and execution practices, we do not believe that disclosure alone will make the markets less fragmented. As you know, we strongly support improved electronic linkages between market centers and price priority across markets. We continue to believe that improved electronic linkages between market centers must be developed in order to ensure that broker-dealers can access the best quotes available in the market for their customers. In addition, a market-wide trade-through rule would promote investor protection by ensuring that no order will be executed at a price inferior to the price displayed in any other market center, while at the same time providing the opportunity for market centers to compete based on factors other than price alone.

The Committee notes that in a companion release the Commission has proposed a rule that would require broker-dealers effecting transactions in listed options to disclose to their customer when the customer's order traded at a price inferior to the best quote published in the

² Securities Exchange Act Release No. 34-42450 (February 23, 2000), 65 FR 10577.

³ Securities Exchange Act Release No. 34-43084 (July 28, 2000), 65 FR 48406, at 48408.

options quote reporting system.⁴ The Release states that this may provide strong incentives for market centers to develop effective access to all market centers, without the Commission mandating a particular form of linkage. We respectfully disagree.

The Committee believes that the proposed disclosure will not provide adequate incentives for market participants to construct effective intermarket linkages. The Commission's focus should be on the markets to develop linkages, not on broker-dealers to make new disclosures of information that the markets already have. Such disclosure may confuse investors and will shift the burden of resolving the trade-through to the broker-dealer who entered the order on behalf of the customer, even though that broker-dealer may have no ability to prevent it. We believe anything short of a market-wide trade-through rule will be ineffective and we urge the Commission to take steps to mandate price priority across market centers.

II. Committee Support for Commission Proposal is Qualified

As we previously stated, the Committee supports greater disclosure of order routing practices and execution quality by market centers.⁵ The disclosure, though, must be fair, meaningful, and should not give rise to new liabilities. As discussed in more detail below, the Committee has concerns with certain aspects of the Commission's proposal in this regard.

A. Execution Quality Will Be Assessed Based Only on Quantitative Factors

Proposed Rule 11Ac1-5 will require disclosure regarding the quality of order executions in various market centers. Such disclosure should enable investors to make informed decisions about where to direct their orders. It should also enable broker-dealers to evaluate the quality of executions among market centers, information that has not always been readily available, in order to fulfill their duty of best execution on behalf of customers. The Committee believes, however, that the measures of execution quality that the Commission proposes elevate price and speed over other, less easily quantifiable, measures that may be equally important to certain investors in assessing execution quality.

As we have previously noted, the definition of best execution varies by investor and type of order. **Orders and investors are not interchangeable.** While one investor may favor fast execution and liquidity guarantees over the potential for price improvement, another investor may be more interested in receiving a better price. Still another investor may place a higher value on anonymity. Indeed, the Commission itself has already recognized that best

⁴ Securities Exchange Act Release No. 34-43085 (July 28, 2000), 65 FR 47918.

⁵ See Letter to Jonathan G. Katz, Secretary, SEC, from Mark B. Sutton, Chairman, SIA Market Structure Committee, dated May 5, 2000.

execution encompasses elements of price, speed of execution, liquidity, transparency, anonymity, reliability, and transaction costs.⁶ The weight accorded to any particular element will vary depending on the investor and the type of order being placed.

While market centers compete based on all of these elements, the Commission's proposal focuses primarily on price and speed in assessing execution quality (*i.e.*, effective spread, rate of price improvement and disimprovement, fill rates, and speed of execution). Other elements that are less easily quantified but no less important in determining where to route orders for certain investors are not factored into the equation. Order flow may therefore be directed based on a superficial analysis of too few criteria. For example, the effective spread may be important to some investors but others may place a higher value on the ability to get an entire order executed when the size of the order exceeds the quote (*i.e.*, size improvement). Indeed, firms that risk their capital to guarantee the national best bid and offer up to a certain amount of shares may be providing more liquidity than a firm that improves the national best bid and offer, but only for a small number of shares. This will be particularly true in a decimal trading environment where the cost of price improvement can be as little as a penny. Nevertheless, this element would not be measured or disclosed under the Commission's proposal.

B. Certain Data Elements May Be Unnecessary

Rule 11Ac1-5 will require statistical information categorized by individual security, by five types of orders, and four order sizes from all market centers, which will include any exchange specialist, OTC market maker, alternative trading system, national securities exchange, and national securities association. For certain market centers, particularly market makers that cover hundreds of securities, this is a significant amount of data. Therefore, in the interests of both producers and consumers of this information, the Commission should be certain that each data element is relevant and necessary to determine execution quality. In this regard, the Committee questions how meaningful some of the data will be. For example, average realized spread is calculated using the midpoint of the consolidated best bid and offer thirty minutes after the time of order execution. This creates a meaningless statistic, especially in light of today's volatile markets, as it is based on something that happened 30 minutes earlier. The Commission also proposes collection and disclosure of data relating to orders canceled prior to execution. The Committee believes that this measurement serves no useful purpose and should be eliminated.

⁶ See Securities and Exchange Commission, Second Report on Bank Securities Activities, at 97-98, n. 233 as reprinted in H.R. Rep. No. 145, 95 Cong., 1st Sess.

Rule 11Ac1-6 will require broker-dealers to disclose, on request of a customer, the identity of the venue to which the customer's orders were routed for execution in the six months prior to the request. This requirement will be duplicative because the order execution venue generally is disclosed on the trade confirmation (*e.g.*, pursuant to New York Stock Exchange Rule 409 for NYSE-listed securities) and so this disclosure would be redundant in many cases.

C. Proliferation of Information May Give Rise to Private Lawsuits

The Committee believes the proliferation of information collected pursuant to proposed Rules 11Ac1-5 and 11Ac1-6 may expose market centers to unwarranted liability. Specifically, like the industry's experience shortly after the Commission mandated disclosure of payment for order flow practices, one can reasonably expect a flurry of class action lawsuits alleging that order entry firms violated their duties to customers by failing to route orders to market centers that allegedly provided better execution quality.

Armed with data from market centers on execution quality and order entry firms' disclosures on their order routing practices (and factors that go into that determination), the plaintiff's bar will attempt to convince customers that they have been denied best execution and will file dubious claims against broker-dealers alleging that they have breached a duty to their customers. Even if firms are successful in defending their executions, the cost of defending against such actions could be devastating. Moreover, to avoid potential litigation, firms may route orders based on the limited elements covered by the market center disclosures and ignore elements that are less easily quantified but nevertheless important in assessing execution quality. Clearly, this is not a consequence intended by the Commission nor one that would serve a useful purpose.

The Committee believes the Commission must provide protection from private lawsuits of this nature. We urge the Commission to make clear, as they did in the context of Regulation FD,⁷ that Rules 11Ac1-5 and 11Ac1-6 are not designed to create new private rights of action under the anti-fraud provisions of the federal securities laws. The Commission should make clear that private plaintiffs cannot rely solely on the information disclosed pursuant to Rules 11Ac1-5 and 11Ac1-6 as a basis for a private right of action absent a pleading of scienter sufficient to state a claim of fraud under Rule 10b-5. The Commission should clearly state that best execution is based on the facts and circumstances of a particular order and claims based on the disclosures are not appropriate for class action treatment.

⁷ See Securities and Exchange Commission Release No. 33-7881, 34-43154, IC-24599 (August 15, 2000), 65 FR 51716.

III. Further Action to Strengthen Competition in the Market

The Commission states in the Release that it is considering further ways to improve the existing national market system to better achieve the objectives of price competition and price priority within the existing market structure. As we have previously noted, the Committee believes a market-wide trade-through rule would strengthen price priority in the equities market. Market-based incentives such as trade-through disclosure will be insufficient to force linkages between market centers. Instead, mandated linkages should be developed to enable broker-dealers to access the best quotes available across many market centers, and we believe the Commission should act promptly to facilitate this. With respect to other initiatives the Commission is considering, the Committee believes the Commission should monitor the impact of decimalization and other recent structural changes (*i.e.*, the repeal of NYSE Rule 390) before taking further action.

IV. Conclusion

While increased disclosure of execution quality advances certain laudable goals, it does not necessarily address the adverse effects of market fragmentation identified by the Commission. Broker-dealers and investors will benefit if they have accurate, useful information about the quality of executions in various market centers. In order to present accurate information, though, each data element must be meaningful and the data as a whole must incorporate all elements, including those that are not easily measured, that determine execution quality. The Commission proposal falls short in this regard. In addition, the availability of this wealth of statistical information invites frivolous lawsuits against those broker dealers whose executions appear inferior to a standard set by reviewers of the data. This would be an unfortunate result of enhanced disclosure, which most believe is good for the industry. The Commission should act to forestall this.

In order to balance the effect of the disclosures, the Commission also might redouble its efforts to educate investors about how markets work and how orders are handled. Indeed, recent Commission initiatives may be creating unrealistic expectations that investor orders will always be executed at prices equal to the displayed quotes at the time the orders are submitted.

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The Committee appreciates the opportunity to provide comments on this important Release. If we can provide further information or clarification of points made in this letter, please contact Judith Poppalardo, Associate General Counsel, at 202-296-9410.

Sincerely,

Mark B. Sutton
Chairman
Market Structure Committee

CC: The Honorable Arthur Levitt, Chairman
The Honorable Isaac C. Hunt, Jr., Commissioner
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The Honorable Laura S. Unger, Commissioner
Annette Nazareth, Director, Division of Market Regulation
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