

**Securities Industry Association**

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February 26, 1996

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

Re: SEC Proposed Order Execution Obligations

Dear Mr. Katz:

The Securities Industry Association ("SIA")¹ and its Ad Hoc Committee on Order Execution (the "Committee") appreciate the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") regarding the Commission's release on the handling and execution of customer orders ("Release").² We hope that by expressing our views we will assist the Commission in shaping optimal public policy for investors and the trading markets.

The Commission proposed two new rules and two rule amendments in an effort to improve the handling and execution of customer orders in the nation's securities markets. The general thrust of the proposals is to move the operation of dealer markets in the direction of auction markets. They would do this by requiring market makers, as well as exchange specialists, to: (i) publish quotations for listed securities where the exchange or market maker trades more than 1% of the aggregate trading volume for the security; (ii) quote to the public any better price that they privately quote through electronic systems; (iii) display customer limit orders priced better than the specialist's or market maker's quotation; and (iv) provide customer market orders some opportunity for price improvement before executing the order. Because we believe in the need for both auction and dealer markets, we oppose any effort to dilute the essence of the principal market.

Since before the 1792 Buttonwood Tree agreement from which the New York Stock Exchange arose, trading markets have depended on market makers, such as exchange specialists and dealers, to provide market liquidity. In 1934, after much public debate, Congress chose to preserve the role of these market makers, a result that Senate counsel Ferdinand Pecora, the chief draftsman and instrumental proponent of the Securities Exchange Act described as a "happy compromise."³ In the succeeding 62 years, our secondary market structure, based on highly competitive exchange specialists and dealers, has produced the most liquid and successful capital markets in the world. Moreover, since 1934, and particularly since the adoption of the 1975 amendments to the Securities Exchange Act creating the National Market System ("NMS Amendments"), the United States has developed a keen and healthy competition

between the world's largest and finest auction markets and the largest and finest dealer market. It is critically important to strike a regulatory balance that preserves and enhances the vitality of competition among market makers, as well as competition between auction and dealer markets. The goal should be to seek more transparency and more effective price discovery in both markets, without going so far as to imperil the role of market makers or to favor one type of market structure over the other.

I. General Concerns.

Summary. The release emphasizes the Commission's belief that the proposed rules should "enhance transparency in our markets and improve the handling and interaction of customer orders" as well as "fair competition among markets and market participants." ⁴ These are laudable goals, and we wholeheartedly support them. However, we have reservations about whether the proposed rules taken as a whole would achieve these goals. To some degree we are concerned that the proposed rules could have unintended consequences, undermining these and other important public policy concerns by draining liquidity from dealer markets and weakening competition between dealer market systems and auction market systems. We also are troubled about whether the proposed rules square with the directive in Section 11A(a)(2) that the Commission "facilitate" a national market system (rather than seek to design and create one itself) and the clear public policy preference embodied in Section 11A of the Exchange Act, favoring competitive forces over regulatory fiat in shaping changes in market structure. These concerns counsel in favor of a more cautious and incremental approach than is generally reflected in the Commission's release.

Competitive Concerns. We are concerned that the proposals could have an overall anti-competitive effect, draining liquidity from dealer markets and thus making them a less robust alternative to auction markets. ⁵ As discussed below, this concern is rooted both in the overall lack of analysis in the Release about possible consequences of the proposed rules, and in specific concerns that we have about the limit order rules as proposed and the price improvement rules.

The current healthy interrelationship between dealer and auction markets could become unbalanced by some of the Commission's rules as proposed. Although this would obviously be to the severe detriment of dealers, who could lose significant revenue or exit the business entirely, the more significant long-term harm would fall on issuers and investors. If the liquidity of dealer markets was significantly diminished, those markets would be weaker competitors with auction markets for issuer listings. Issuers, particularly newer and smaller companies, would face higher costs in raising capital, and have few if any choices in selecting the type of market in which they would like their stock to trade. Likewise investors would have far fewer choices, both in the types of companies in which they can invest and the types of markets in which they would like to participate.

The Release invited comment on another competitive issue, whether the Intermarket Trading System ("ITS") should provide equivalent access for market makers in non-19c-3 securities. The SEC's proposed broadening of the requirements for mandatory quotations, which is discussed below, will require market makers to register as Consolidated Quotation System ("CQS") market makers. By complying with CQS standards, this should eliminate any objection to the continued exclusion of market makers from ITS on an equivalent basis with other ITS

participants. We support the Commission's interest in addressing this issue.⁶

Statutory Preference for Market-Driven System Changes. The proposal must be measured against the statement in Section 11A(a)(2) that the SEC's role should be to "facilitate . . . the establishment of a national market system." This would seem to strongly counsel, if not mandate, some degree of "field testing" before permanently altering fundamental market structure. Yet the proposed rules represent a preference for complete transformation of market systems in the first instance, bypassing any opportunity for pilot programs or trial runs. These specific and sweeping proposals appear to reflect a number of a priori judgments by the Commission about the appropriate structure of competing market centers. It is doubtful that Congress had this sort of role in mind for the Commission when it enacted the NMS amendments.

Need for Further Study. Most of our comments are grounded in the fact that the potential consequences of some of the proposed rules have simply not been adequately explored by the Commission. We have a basic concern that some of the proposed rules are untested and could have a range of adverse effects on liquidity and competitiveness. Regrettably, the Release reflects only a perfunctory effort by the Commission to grapple with these issues. We believe that the Commission should offer a better demonstration that it has carefully appraised the possible consequences of its proposed rules.

The uncertainty about the impact of the rules needs to be placed in the context of the significant problems that now exist with the Nasdaq Stock Market's Small Order Execution System ("SOES"). As the Commission is no doubt aware from many comment letters submitted in connection with the pending rule proposal on N Aqcess,⁷ many market participants have serious concerns that SOES, despite its praiseworthy purpose of benefiting small investors, lends itself to significant abuses by professional traders which hurt Nasdaq market makers and investors and impair liquidity. While this letter does not address the merits of the N Aqcess proposal, the fact is that the adverse effects of current SOES abuses have not been resolved to date. Therefore, the Commission should be especially cautious about imposing additional untested requirements and structural changes which could unintentionally add to existing encumbrances on dealer participation and liquidity.

An additional concern is the Release's fairly thin attention to the potential impact of its proposed rules on institutional investors. While the Release demonstrates laudable concern for the manner in which retail orders are handled, we think it is important to recognize that institutional investors, such as mutual funds and pension funds, are typically aggregations of small individual investors. Therefore, if improved handling of retail orders were to occur at the expense of efficient execution of institutional orders it is not clear that individual investors generally would benefit. Moreover, institutional investors play a critical role in providing liquidity in the securities of many issuers. The Commission should give more explicit consideration to the potential consequences of the proposed rules for institutional investors, and for the liquidity that they provide in many markets.

We join in the concerns expressed by the NASD in its comment letter, which noted that (i) the SEC should better quantify the impact of the proposed rule changes in its Regulatory Flexibility Analysis; (ii) the SEC should include an analysis of its Electronic Communication Network ("ECN") proposal in the Regulatory Flexibility Analysis; (iii) the Commission's estimates under

the Paperwork Reduction Act are too low, and need to be revised and extended to include the proposed safe harbor under Rule 11Ac1-5; and (iv) the Commission's cursory analysis of the possible anti-competitive impacts of its proposals does not satisfy the requirements of Section 23(a)(2) of the Exchange Act.⁸

A comprehensive analysis of these issues is admittedly difficult. However, the Commission has an obligation, both as a matter of responsible public policy and as required by the above-cited statutory provisions to perform a more substantial analysis of the potential impacts of such sweeping regulatory proposals. If the Commission feels that it lacks the information or the resources to conduct such a review, it should consider other avenues, such as convening a round table discussion among affected parties or establishing an advisory board.⁹

II. Comments on Specific Rule Proposals.

A. "Quote Rule"

We support the Commission's proposed amendment to Rule 11Ac1-1, (the "quote rule") which would require the most active exchange and market makers in non-Rule 19c-3 securities to become registered as CQS agents and disseminate continuous two-sided quotations. We believe that the threshold proposed by the SEC of 1 per cent of the aggregate trading volume in a reporting security is a reasonable test.¹⁰ Additionally, we support the Commission's proposal that the definition of Market Maker should be limited to those dealers who continuously hold themselves out as willing to buy and sell securities in less than block size and should not encompass principal trades executed by exchange members on an occasional basis during market hours.

In relation to the proposed amendment to Rule 11Ac1-1, the Release invited comment on whether computer generated quotations should be permitted if mandatory quotation is extended to active market makers in non-19c-3 securities. We understand that the regulatory concern here is to address the issue of computer-generated quotations that merely "track" the market for the purpose of avoiding trading without contributing to liquidity or price discovery. We assume that the Commission would not wish to impair the use of computers in a manner that helps market makers to meet their responsibilities by providing accessible quotations. The goal of regulators should be, as the NASD stated in its comment letter, to permit "the generation of automated quotation where the market maker is genuinely acting as a contributor to market liquidity and where that generation does not pose enormous impact on system capacity." In addition, there is an understandable regulatory concern that without reasonable restrictions, computer-tracking quotations, coupled with an expanded definition of market makers required to display continuous two-sided quotations, could simply overwhelm the capacity of NASDAQ screens and vendor systems to report quotations. We agree that any restriction on computer-generated quoting should reflect the precept that such trading is permissible as a way to trade, but impermissible as a way to avoid trading. There may also be other ways of addressing the issue of market makers who are seeking to avoid a trade. Regulators should be able to address this issue without imposing limitations on the legitimate use of computer technology.

B. Display of Electronic Communication Quotations.

The Commission proposes that the prices of market maker orders disseminated in an ECN

should be reflected in their individual quotations. We understand that dealers that internalize customer order flow, and dealers that hold themselves out to particular firms as willing to execute their customer order flow, would not be considered to be ECNs, but their order flow would be included in the measurement of the 1% of aggregate trading test that triggers the requirements of the "quote rule".

We believe that price discovery and transparency would be enhanced by some form of public display of ECN prices. The Committee is divided over whether this would be best achieved by the Commission's approach of requiring market makers to publish their ECN quotations, or by simply reflecting ECN quotations on the inside market display without disclosing the market maker that made the quotation, as the NASD's comment letter recommends. The lack of consensus among the Committee suggests that this is an area where the SEC should proceed with great caution. In weighing this issue the Commission should also carefully consider what impact publication of ECN quotes might have on the adaptation of new technology and the variation of trading methods available in the market.

C. Limit Orders

The Commission's proposed Rule 11Ac1-4 would require an exchange specialist or market maker to publish a customer limit order that it holds if it improves the specialist's or market maker's bid or offer in the security. This requirement would extend to all exchange-listed securities, Nasdaq National Market securities, and Nasdaq SmallCap securities. The Release states three concerns underlying this proposal: that failure to display limit orders artificially widens spreads; that it reduces quotation competition and impairs price discovery; and that it results in small orders being executed at inferior prices.

While SIA members have a range of views on this proposal, the consensus view of the Committee is that limit orders should be reflected in market maker's quotations.¹¹ Greater public display of limit orders will enhance transparency and should enable more efficient execution of those orders. Nevertheless, we oppose requiring that size be mandated in limit order quotations. We are concerned that mandated display of order size could invite front-running, and that this could impair both the quality of the execution obtainable for the limit order and liquidity, without improving transparency.

We are also concerned that limit order display could impair the liquidity of many Nasdaq stocks, particularly issues with a smaller trading volume. In addition, we question whether in some instances mandated limit order display would be an unwarranted intrusion on a broker's professional judgment as to whether displaying a limit order assists or detracts from the broker's best execution obligation. Neither the SEC nor SIA has the benefit of any experience or empirical evidence about what the impact of limit order display might be on market liquidity. Consequently, we urge that mandatory limit order display should initially be limited to categories of securities as to which the liquidity concerns are less compelling. Once the Commission has a chance to observe the impact of limit order display on those securities, it could consider whether to broaden the application of the requirement. Accordingly, we recommend that the Commission initially restrict mandatory limit order display for Nasdaq National Market stocks to the 250 NASDAQ National Market stocks with the highest average daily trading volume.

D. Price Improvement.

Under proposed Rule 11Ac1-5, a market maker that accepts a customer market order in certain securities would be required to provide the order an opportunity for price improvement. Although the proposed rule does not mandate a methodology for price improvement, it contains a non-exclusive safe harbor with order exposure procedures that would be deemed to satisfy the requirement.

We believe that this is the most sweeping of the SEC's proposed rules and is unnecessary. The SEC's goals will be accomplished through its limit order proposal (either as proposed or with our recommended modifications). We also believe that the impact of the price improvement proposal is even more difficult to evaluate than the other proposals, and the implementation costs far higher. We also oppose this proposal because, as the Department of Justice has pointed out, it "may impose more in compliance and enforcement costs than it delivers in benefits. Moreover, and of significance, the Price Improvement proposal could operate at cross purposes with the Limit Order proposal to the extent that the Price Improvement proposal induces customers to enter market rather than limit orders." ¹² These considerations strongly suggest that consideration of the price improvement proposal is untimely at least until the effects of the other proposals are known.

SIA again wishes to thank the Commission for the opportunity to comment on these major rule proposals. We believe that with more analysis of the consequences of its proposal the Commission will elect to scale back the proposed rules in several respects, resulting in an approach that will be more likely to facilitate transparency and price discovery, and that will reduce the risk of damaging market liquidity. We hope that our comments will assist the Commission as it engages in that process.

If SIA or the Committee can provide further information please contact Stuart J. Kaswell, SIA Senior Vice President and General Counsel or George R. Kramer, Assistant General Counsel, at (202)296-9410.

Sincerely,

A. B. Krongard
Chairman
SIA Board of Directors

Bernard L. Madoff
Co-Chairman
Order Execution Committee

Robert Murphy
Co-Chairman
Order Execution Committee

cc:

Chairman Arthur Levitt
Commissioner Steven M. H. Wallman
Commissioner Isaac Hunt
Commissioner Norman Johnson
Richard R. Lindsey, Director, Division of Market Regulation

Footnotes:

¹ The Securities Industry Association ("SIA") is the trade association representing the business interests of about 750 securities firms in North America. Its members include securities organizations of virtually all types - investment banks, brokers, dealers and mutual fund companies, as well as other firms functioning on the floors of the exchange. SIA members are active in all exchange markets, in the over-the-counter markets and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for 90% of securities firm revenue in the United States.

² Securities Exchange Act Release No. 36310 (September 29, 1995) (the "Release").

³ J. Seligman, *The Transformation of Wall Street*, at 86, 100 (1982).

⁴ Release at 6.

⁵ Section 11A(a)(1)(C)(v) states a preference for investors' orders to be executed without the participation of a dealer, so long as it is consistent with "[e]conomically efficient execution of securities transactions." and the "[p]racticability of brokers executing investors' orders in the best market." Since it is indisputable that for many securities a dealer market is necessary for efficient execution and best price, it would be inconsistent with the policy of Section 11A for the Commission to take steps that could eviscerate dealer markets.

⁶ The Committee's co-Chairman, Mr. Robert Murphy, does not share the Committee's view regarding market maker access to ITS. Mr. Murphy's views have been forwarded to the SEC under separate cover (letter from RPM Specialist Corporation dated February 26, 1996).

⁷ See Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. and Accompanying Rules of Fair Practice, SEC Release No. 34-36548 (Dec. 1, 1995) (File No. SR-NASD-95-42).

⁸ Letter to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, from Joseph R. Hardiman, President, the National Association of Securities Dealers (Comment File No. S7-30-95) at 21-22.

⁹ It should also be noted that the Congress envisioned that market structure changes made in furtherance of a national market system would be undertaken only after careful study and broad external input. Section 11A(a)(3) of the Exchange Act contemplates both that the Commission would undertake studies and that it would convene advisory committees or hire experts before adopting national market system initiatives.

¹⁰ We do not understand the definition of market maker to encompass those who stand ready to bid or offer to selected clients rather than holding themselves out by dissemination of two-sided markets. In the case of a dealer who only stands ready to put its capital at risk for selected clients, and only in response to inquiries from those clients, that dealer should not be deemed a market maker simply because its volume exceeds an arbitrary limit.

¹¹ One Committee member believes that display of the full aggregate size of limit orders is vital to the goal of enhancing market transparency and therefore supports the SEC's limit order proposal in its entirety. We understand that one or more SIA members are opposed to the limit

order proposal in its entirety.

¹² Comments of the United States Department of Justice Regarding Proposed Rules to Improve the Handling and Execution of Customer Order (Comment File No. S7-30-95) at 9.

For more information, please contact [George Kramer](#) or [Stuart Kaswell](#).