Securities Industry Association

120 Broadway, New York, NY 10271-0080, (212) 608-1500, Fax (212) 608-1604
1401 Eye Street, NW, Washington, DC 20005-2225, (202) 296-9410, Fax (202) 296-9775
info@sia.com, http://www.sia.com

August 1, 1996

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

Re: SEC Proposed NAqcess Systems

Dear Mr. Katz:

The Trading Committee of the Securities Industry Association ("SIA") [1] 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") and the Nasdaq Stock Market, Inc.'s ("Nasdaq") proposed NAqcess system. The NAqcess system, as originally proposed, was designed to assist investors in achieving prompt, efficient executions of their small orders and to provide an opportunity for price improvement over the dealer quotation within an automated execution environment. Subsequent to the NASD's filing of the original NAqcess proposal, [2] the SEC proposed significant changes to SEC rules that will dramatically alter the way customer limit orders are handled and executed in the U.S. equity markets. [3] The general thrust of the SEC proposals is to move the operation of dealer markets in the direction of auction markets. While the NASD believed that NAqcess was consistent with the Commission's Order Exposure Release, the NASD is nevertheless now proposing refinements to NAqcess that "are even more closely configured to the SEC's approach." [4]

The original NAqcess proposal offered nationwide limit order protection and price improvement opportunities for customer orders through the operation of a limit order facility with an automatic execution feature. The NASD believed this was a significant advance in terms of both the transparency of the Nasdaq Stock Market and increased access to faster executions and better prices for retail customers. Through this amendment, the NASD proposes to further enhance Nasdaq's transparency and customer access to prompt executions by increasing the size of limit orders eligible for entry and permitting market makers to enter proprietary market and limit orders.

We note that the NASD first proposed NAqcess in response to concerns about the utility of the mandatory Small Order Execution System ("SOES"). SOES was designed to provide immediate execution for small retail orders in the absence of telephonic communication. However, the system lends itself to abuses by professionals posing as individual investors. We commend the NASD for undertaking to correct the inequities in SOES but we have identified a number of areas, discussed in more detail below, where we do not believe the possible consequences of this far-reaching proposal have been adequately explored by the NASD. We believe the comprehensive changes proposed in Amendment No. 2 will alter fundamental market structure and should not be approved without a careful evaluation of the potential economic impact of these sweeping regulatory changes. Moreover, we believe such sweeping changes ultimately may be unnecessary in light of the Commission's imminent release of the order handling rules, [5] which apply across the board to all market centers.

Lack of a Market-Wide Trade-Through Rule

The Trading Committee believes that in the absence of a market-wide trade-through rule, the system operates to disadvantage market makers. If a market maker chooses to hold limit orders outside of NAqcess, the market maker is required to protect those orders, i.e., provide fills to customers, to the same extent as orders in the NAqcess system. It is unfair that a transaction can take place at a price inferior to a market maker's quote. Because a market maker will be obligated to its customer to provide a fill for a limit order reflected in the market maker's quote, the rule in effect forces market makers to put all orders in NAqcess. If a market maker's quote is not given the same protection as a NAqcess bid or offer, the NASD is setting up an exchange to compete with its own members.

Rules Operate to Unfairly Preference the NASD's Own System

Dealer markets depend on order flow. The order execution feature of NAqcess puts Nasdaq in the position of competing with its members for order flow. As noted above, the rules operate in such a way that NAqcess will become the system of choice. The Committee acknowledges the need to provide a mechanism for the immediate delivery of small retail orders, and we believe that certain features of NAqcess may provide this, [6] but such a system should operate as an option, not as the primary system that competes with market maker proprietary systems and other electronic communication networks created to meet investors' liquidity requirements. Such a system should be limited to orders for 1,000 shares and under, seeking immediate delivery for execution against SEC-mandated best price quotations.

We believe the goals of NAqcess are laudable and we fully support the NASD's objective of providing greater transparency and increased access to faster executions and better prices for retail customers. However, as the SIA stated in its comment letter on the Order Exposure Release, we oppose any effort to dilute the essence of the dealer market in favor of auction market principles. 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. The NAqcess limit order file imposes auction market principles on a dealer market. While auction market principles operate well in deep and liquid markets, where there is insufficient depth and liquidity, the involvement of dealers is required to provide firm two-sided quotes or to commit capital to take the other side of the market in less liquid stocks and in times of market imbalances.

Before taking any action that could lead to the dismantling of dealer markets, the SEC should carefully examine the public policy implications of such restructuring. As the NASD notes in the proposing release, market makers bring significant amounts of capital to bear in support of the trading of new and smaller-capitalized companies in which there may not be significant natural liquidity. A market maker's willingness to sponsor new companies is directly related to its return on capital for the risks incurred. Market maker participation will diminish if Nasdaq does not provide market makers a reasonable opportunity to obtain a fair return on investment. In turn, lack of market maker sponsorship could seriously damage the capital-raising abilities of small issuers at an early stage in their growth.

Impact of the SEC's Order Handling Proposals

The Commission's order handling proposals provide many of the benefits that NAqcess is intended to provide--narrower quotation spreads, greater transparency for limit orders, and the opportunity for price improvement for market orders. Moreover, the order handling proposals would apply to all market centers and therefore would not have the same anti-competitive effect that the NAqcess proposal presents. The SIA also counseled the Commission to adopt a cautious and incremental approach with respect to adoption of these rules and we reiterate that position here. Based on public comment, however, we believe the SEC may be considering a limited approach to implementation of those rules. Adoption of certain of the SEC rules, if combined with a market-wide trade-through rule, could obviate the need for NAqcess as amended. The display of consolidated information maintains the advantages of a competing dealer market while providing expanded information to investors. If market makers are obligated to expose their limit orders in their quotes and are committed to honor and not trade through other superior-priced market maker quotations, there would be no need for the NAqcess system as amended.

The National Market System created by Congress in the 1975 Act Amendments to the Securities Exchange Act (the "Act") contemplated a market structure where customers could get best execution no matter where their orders were displayed or filled. The SEC order handling proposals accomplish this by requiring a dealer to reflect customer limit orders in its quote and by requiring a dealer to make the best bid or offer it makes available through any electronic system available to all investors. The comprehensive changes proposed to the NAqcess system, however, would alter fundamental market structure and could have serious consequences for the maintenance of fair and orderly markets, the liquidity of those markets, and the ability of issuers, especially small issuers, to raise capital.

Before proceeding with such sweeping changes, the Trading Committee believes that the SEC needs to better understand the implications those changes may have on the marketplace. We therefore strongly urge the SEC to defer consideration of the NAqcess proposal until it has had an opportunity to analyze the potential impact of these sweeping regulatory changes. At a minimum, the SEC should defer taking final action on this proposal until it has observed the operation of the order handling rules. If the SEC determines to go forward, NAqcess should be implemented on a limited, pilot basis in order to identify possible consequences of the proposed rules and to expose the inevitable "bugs" that could show up in such an elaborate plan.

Specifically, the Committee has identified several aspects of the proposal that could be problematic. For example, opening procedures, print protection, and a market maker's rights and responsibilities if an erroneous report hits the tape are issues that will impact firms' proprietary order entry and execution systems. The possible ramifications of the proposal in these areas and others too numerous to list have not been studied adequately. Prudence, therefore, dictates a cautious, measured approach.

The Trading Committee again thanks the Commission for the opportunity to comment on these major rule proposals. We hope that the Commission will agree that it is critical to preserve the benefits that a competitive dealer market provides and that these sweeping market structure changes should be implemented only after the Commission has assessed the impact of the order handling rules and determined that additional changes are necessary in furtherance of the purposes of the Act. We look forward to being involved in this process.

If the Committee can provide further information please contact the undersigned, or Judith Poppalardo, SIA Assistant General Counsel, at (202) 296-9410.

Sincerely,

A. B. Krongard
Chairman
SIA Board of Directors

Bernard L. Madoff
Chairman
Trading Committee

cc:
The Honorable Arthur Levitt, Chairman, SEC
The Honorable Steven M.H. Wallman, Commissioner
The Honorable Norman S. Johnson, Commissioner
The Honorable Isaac Hunt, Jr., Commissioner
Dr. Richard 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 exchanges. 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. This and other recent SIA comment letters can be found on SIA's Internet home page, http://www.sia.com/.

[2] Securities Exchange Act Release No. 36548 (December 1, 1995), 60 FR 236.

[3] Securities Exchange Act Release No. 36310 (September 29, 1995), 60 FR 52792 ("Order Exposure Release"). The Release proposed two new rules and two rule amendments that would require 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.

[4] Securities Exchange Act Release No. 37302 (June 11, 1996), 61 FR 120.

[5] See supra note 3.

[6] By allowing market makers 20 seconds upon receipt of a marketable order to accept or decline such an order, Nasdaq market makers are on equal footing with other NMS and Nasdaq market participants who make use of state-of-the-art technology to take advantage of the present inequities in SOES. If the Commission determines to defer consideration of NAqcess, we request the opportunity to provide additional comments on this point in order to avoid reactivation of the SOES rules.

For more information, please contact Judith Poppalardo.