INVESTMENT COMPANY INSTITUTE

CRAIG S. TYLE
GENERAL COUNSEL

May 12, 2000

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Stop 6-9
Washington, DC 20549

Re: Commission Request For Comment on Market Fragmentation (File No. SR-NYSE-99-48)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's concept release regarding market fragmentation.[2] The structure of the securities markets has a significant impact on our members, who are investors of over $7 trillion of assets on behalf of over 78 million individual shareholders. The Institute and its members, therefore, have a keen interest in ensuring that the securities markets are highly competitive, transparent and efficient, and that the regulatory structure that governs the securities markets encourages, rather than impedes, liquidity, transparency, and price discovery. Consistent with these goals, we have strongly supported past regulatory efforts to improve the quality of the U.S. markets.[3] We commend the Commission for these efforts, of which the Concept Release is the latest example.

The Institute concurs with the prevailing view that the U.S. securities markets are the preeminent markets in the world. Our markets provide unparalleled liquidity, combined with stringent regulatory oversight designed to ensure the protection of investors. Mutual funds and

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,034 open-end investment companies ("mutual funds"), 496 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.024 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

[2] Securities Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10577 (February 28, 2000) ("Concept Release").

[3] *See, e.g.*, Letter from Craig S. Tyle, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 16, 1996 (File No. S7-30-95) (Order Execution Obligations); Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated July 28, 1998 (File No. S7-12-98) (Regulation of Exchanges and Alternative Trading Systems); Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated September 2, 1998 (File No. 4-208) (Proposals to amend the operations of the Intermarket Trading System) and Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 11, 2000 (File No. SR-NASD-99-53) (Nasdaq Order Display Facility).

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their shareholders have benefited accordingly. Nevertheless, there remain some significant shortcomings in our markets, which can and should be remedied. Some of these have become more apparent as technology has outpaced structures – such as the Intermarket Trading System ("ITS") – that were developed over 20 years ago. Others are seemingly becoming more prevalent as our markets evolve, such as internalization. Still others – such as the lack of meaningful priority rules between markets – are longstanding.[4] The Concept Release affords the Commission the opportunity to address these concerns to the benefit of all investors.

Our specific comments are set forth below. We first address our concerns with current market structures, in particular those that have contributed to fragmentation. We then discuss our recommendations to address these concerns. Our principal recommendations fall into two categories. In the long-term, we believe that the Commission should establish an intermarket price/time priority rule for displayed orders. We recognize, however, that such a price/time priority based system will only prove effective if there exist, among other things, systems that are capable of effectively routing orders between markets and standards for order execution within markets. Consequently, we also recommend that the Commission implement other changes more immediately. These include requiring greater transparency of limit orders, a price improvement rule for internalized orders, and rules requiring price/time priority *within* markets.

I. Concerns Regarding Fragmentation

"Fragmentation" refers to the trading of orders in multiple locations without interaction among those orders. Fragmentation adversely affects the ability of customer orders to interact with one another as broadly as possible. This can force mutual funds and other investors to look to several different sources to find sufficient liquidity to effectively complete a trade, especially a large trade, at the best price. It also can, as noted in the Concept Release, act to discourage investors from displaying limit orders, as it reduces the chance that such orders will be executed. As a result, transparency and liquidity are reduced and spreads likely are wider than they would otherwise be.

Fragmentation arises from many factors. These include internalization, the lack of priority rules across markets, and the lack of robust linkages among markets. In addition, many markets do not provide disclosure of priced orders to market participants, which further inhibits transparency and interferes with the ability of mutual funds and other investors to make informed investment decisions. Each of these points is discussed below.

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[4] The "lack of a mechanism to provide nationwide agency limit order protection" that allows for "time and price priority to such orders" was cited by the Commission as a "major problem" over twenty years ago. *See* Securities Exchange Act Release No. 14416 (January 26, 1978) ("Development of a National Market System").

A. Internalization

Internalization is one form of fragmentation. When a broker-dealer internalizes its orders, those orders are not exposed to other orders in the marketplace. Questions have been raised regarding whether and to what extent an investor receives the best possible price when orders are routed pursuant to internalization arrangements and whether those orders are subject to true price discovery.[5] Even if, however, those orders do receive comparable executions to orders that are not internalized, we believe that the existence of these arrangements reduces the efficiency of the market as a whole by contributing to fragmentation and the consequent problems noted above.[6]

B. Lack of Priority Rules

Currently, there are no rules providing for time priority for limit orders across markets. Therefore, a market participant that publicly displays a limit order setting a new best price in a market is not guaranteed that the order will ever be filled, as that order has no priority over other orders entered later in time. Market centers holding orders that would satisfy the market participant's limit order also have no obligation to route those orders to the price-setting market center. Instead, market makers can trade as principal with their order flow by matching the price-setting order and therefore trade ahead of limit orders held by another market center even if the limit order was displayed prior to any market maker quotation at that price.

In addition, some markets do not even provide time priority on an intramarket basis. For example, while orders on a NYSE specialist's book are accorded priority status by price and time, NYSE rules allow floor brokers to "jump in" and participate in executions notwithstanding priority status. Thus, a mutual fund that sends a price improving order to the floor of the NYSE can have only a small portion of its order filled while the "crowd" – not having seen fit to display orders that contributed to the price discovery process – is able to free ride.

C. Inadequate Market Linkages

There are two primary linkages in the securities markets today, the ITS in the listed market, and SelectNet in the over-the-counter market. As the Concept Release acknowledges, the ITS linkage has weaknesses that must be addressed -- most importantly, slow and inefficient execution procedures. In addition, the NASD's SelectNet system is outdated and technologically inefficient. In fact, in the last several years alone, there have been several

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[5] The NYSE discusses these concerns in its rule proposal to rescind NYSE Rule 390. *See* Concept Release, Section II.A.1.

[6] One market development that may effect internalization is the impending conversion to decimal pricing. Once decimalization becomes effective and spreads narrow, as expected, to as low as one penny in the most actively traded securities, internalization may become less attractive to market makers.

instances where SelectNet has experienced delays and slow response times due to increased volume through its system.

D. Transparency and Depth of Book

While not strictly a fragmentation issue, the Institute believes that the lack of transparency of prices in the securities markets also detracts from liquidity and the price discovery process and consequently is a problem that must be addressed. Currently, most market centers only display the "top of the book," *i.e.*, the best bid and offer on that market center. The recent volatility in the securities markets, combined with the planned conversion from fractional pricing to decimal pricing, makes the level of transparency available to investors today sorely inadequate.

II. Institute Recommendations on Market Structure

The Institute believes that the shortcomings in our markets described above should be remedied and that this can be accomplished without harming those markets' numerous strengths. In the long term, the surest way to accomplish this goal would be for the Commission to mandate price/time priority across all markets. This would ensure that those investors that are displaying limit orders will be afforded protection and priority for such orders and will thus realize the benefits of displaying these orders, thereby encouraging further use of limit orders. As a result, the *entire securities market* would benefit from improved price discovery, liquidity, and tighter spreads. Thus, the Institute believes that the sixth option proposed by the Commission in the Concept Release should eventually be adopted. Such a price/time priority system, however, will only prove feasible once certain conditions are in place. These include the development of systems that allow market participants to efficiently route orders to different markets on a price/time priority basis and the establishment of standards relating to the execution of orders for participating markets. Because these conditions may take some time to be developed and implemented, we believe that the Commission should, in the interim, require all market centers to display a minimum amount of their limit order book (if not their entire book), adopt a price improvement requirement for internalized orders, and require price/time priority on an intramarket basis.

Each of these points is discussed below.

A. Short-Term Recommendations

1. Transparency and Depth of Book

Currently, it is unusual for an investor to be able to view more than the best bid and offer on the limit order books of a particular market center.[7] The Institute strongly supports

[7] There are some exceptions to this limitation. For example, several ECNs make their entire limit order book available for public viewing.

increasing the exposure of limit orders to investors. Increasing transparency in this manner would provide investors with a greater indication of the interest in a particular security and would allow investors to better gauge the market in general. We therefore believe that market centers should make available for public viewing a minimum amount of their limit order book, if not the entire book.

The Institute recognizes that several market centers have been moving towards increased transparency in their respective markets. For example, Nasdaq's Super Montage proposal would display the best bid and offer for a particular security and bids and offers two levels away from the NBBO. Market centers, however, should display greater depth of book than just a few levels away from the NBBO. This will become especially important when decimalization is implemented in the securities markets. If, as expected, the most liquid stocks begin trading in increments as low as one penny, being able to see only the top of the book will provide investors with *less* information as to the trading interest in that security than before, as there will be a much larger number of pricing levels below the NBBO.

We commend the Commission for recognizing the importance of limit order transparency and are pleased that the Commission held a roundtable on this issue to create a dialogue among market participants. In furtherance of this goal, the Institute and the Securities Industry Association have agreed to form a joint industry group bringing together market participants on both the buyside and the sellside of the securities industry to examine issues regarding limit order transparency. As Chairman Levitt stated in announcing the roundtable, "In addition to being an invaluable tool for investors, limit orders are the building blocks of transparency in our market, and a proven stimulant of price competition."[8] We look forward to working with the SIA and its members, as well as the Commission, on this important matter.

2. Price Improvement

One of the options suggested by the Commission in the Concept Release would require that broker-dealers only internalize customer order flow if they provide for price improvement, *i.e.*, a price that is better than the national best bid or offer against which the order might otherwise be executed. As we have previously commented, the Institute strongly supports such a price improvement requirement, which would promote the interaction of orders in the securities markets and discourage internalization, or at least help ensure that investors receive a fairer price for internalized orders.[9]

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[8] *See* Securities and Exchange Commission Press Release No. 2000-50. The importance of the transparency of limit orders also was acknowledged in a recent special study by the Commission's Office of Compliance Inspections and Examinations and the Office of Economic Analysis analyzing the display of customer limit orders. In that study, Commission staff found that "Limit orders serve a critical market function by increasing the information available to the overall market and by allowing all market participants to better determine prices." In addition, Chairman Levitt, in discussing the report's findings, stated that "Limit orders have been a powerful force for competition in our markets – narrowing spreads, increasing transparency, and supplying liquidity... Their effect on the price setting process simply cannot be compromised." *See* Securities and Exchange Commission Press Release No. 2000-59.

[9] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary,

3. Price/Time Priority Within Markets

As discussed below, the Institute believes that the Commission should, when certain conditions have been satisfied, mandate intermarket price/time priority. In the interim, the Commission should mandate price/time priority *within* markets. Mandating price/time priority on an intramarket basis would ensure that a limit order entered on a given market will be filled prior to a limit order on that same market that is entered at the same price but later in time. This would rectify, for example, the situation described above concerning the lack of priority rules on the NYSE floor.

B. Intermarket Price/Time Priority

While each of the recommendations above would improve the functioning of our markets by reducing fragmentation and encouraging the display of priced orders, the Institute believes that they would not sufficiently address the issue of how to provide for the interaction of orders entered into different markets. Simply put, if an investor places a limit order in a market that sets the best price across all markets, it is only fair for that investor to have its order executed first. Indeed, our members report that without adequate protections for limit orders, they often are reluctant to place these orders for fear that they will go unexecuted while at the same time they are used as a basis for other investors to trade against.

Accordingly, after careful consideration, we have concluded that the sixth option set forth in the Concept Release – intermarket price/time priority – should be adopted. We believe, however, that such a system could only be effectively implemented once certain conditions are met. These conditions, and other important elements of an intermarket price/time priority system, are discussed below. We also address objections that have been made to price/time priority.

1. Elements of a Price/Time Priority System

Scope. The Institute believes that an intermarket price/time priority rule should apply to all displayed trading interest in the market during normal trading hours.[10] The Concept Release set forth, as alternatives to intermarket price/time priority, two weaker versions of such a rule. Under one version, the Commission would provide priority only to customer limit orders and

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Securities and Exchange Commission, dated March 20, 2000 (File No. SR-NYSE-99-48) (Rescission of NYSE Rule 390). The Commission requested comment on whether restricting internalization would unduly interfere with competition among market centers to provide trading services based on factors other than price, such as speed, reliability, and cost of execution. The Institute does not believe this would be the case. As discussed below, market centers, in order to compete, would still have to provide these services to customers or else risk losing order flow to more efficient market centers.

[10] Otherwise, we believe there will be difficult, if not insurmountable, problems in determining how to treat orders entered during the trading day in an after-hours trading environment.

would not include broker-dealer principal trades. We see no purpose in drawing these distinctions between customer orders and proprietary orders. Both types of orders provide liquidity to the markets and facilitate price discovery. Moreover, such a rule likely would result in difficult "line drawing" questions.

Under another version discussed in the Concept Release, the Commission would establish intermarket trading priorities that grant time priority *only* to the *first* limit order or dealer quotation that improved the NBBO for a security. We believe that this would be inadequate. Subsequent orders or quotations that match the improved price also are valuable to the markets as they indicate greater depth at that price. In addition, applying price/time priority to all orders will provide an incentive to market participants to place limit orders.[11]

Linkages. The Commission has indicated that it does not intend to dictate a specific market structure and supports allowing competition in the markets to develop the technology needed to restructure the markets.[12] The Institute supports this flexible approach. In contrast, we would not support the creation of a single industry utility to link markets and to route orders to them. Among other things, this could discourage innovation and create a single point of failure that could shut down our securities markets.

Accordingly, the Commission should permit markets and market participants themselves to determine how to structure linkages that would provide access to all markets and route orders according to price/time priority. Ideally, there should be a multitude of entities that provide these services to investors. Such entities, presumably, would have to operate on a "real time" basis, with orders being routed in accordance with price/time priority and with the priority being immediately updated to reflect executions and cancelled orders.[13] We are confident that the technology to make this possible can and will be developed, but we would not recommend that the Commission require intermarket price/time priority until this has occurred.

Order Execution Capability Standards. Markets that participate in an intermarket price/time priority based system should be required to meet certain standards with respect to their order execution capabilities. Otherwise, an investor could be forced to have its order sent

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[11] For this reason, the Institute opposes the third option set forth in the Concept Release, which would require that all market centers expose their market and marketable limit orders to price competition. As we previously commented on a similar proposal, such a rule would *discourage* the display of limit orders by market participants. *See* Letter from Craig S. Tyle, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Commission, dated January 16, 1996 (File No. S7-30-95) (Order Execution Obligations). We also continue to have concerns with the potential ramifications of a delay in the executions of transactions, especially for the most actively traded securities where investors need to respond quickly to a changing market environment.

[12] *See* "Visible Prices, Accessible Markets, Order Interaction," Speech by Securities and Exchange Commission Chairman Arthur Levitt (March 16, 2000).

[13] This is needed in order to avoid a situation in which a market participant's order is routed to a market for execution against an order that is no longer available.

to a market that, for example, is slow in executing orders. This could harm the investor, as orders displayed in other markets could be cancelled (*e.g.*, in a fast moving market) while it is waiting for the first order to be executed. Thus, we would recommend that the Commission develop standards regarding order execution capabilities for markets as part of an intermarket price/time priority system.[14] Only orders entered into markets that meet such standards would be entitled to protection on a price/time priority basis. (Markets that do not meet the standards should be required to prominently disclose this fact and the consequences to investors entering orders into these markets.)[15] In addition, we would recommend that once such standards are adopted, they be re-examined on a frequent basis, so that they do not come to serve as a disincentive to future technological innovation.

Reserve Size Function/Block Transaction Exception. The Concept Release requests comment on whether a market structure employing price/time priority should incorporate a reserve size function and whether there should be any exceptions from a price/time priority requirement for block transactions or for intra-market agency crosses at the NBBO. The Institute believes that markets should be able (but not required) to provide for a reserve size function. A reserve size feature allows investors to "refresh" displayed orders as those orders are executed against.[16] In addition, while our members, as institutional investors, do make use of block transactions and intra-market agency crosses at the NBBO, we believe that in the market structure we are proposing, an exception for these types of transactions would be unnecessary. We believe it is important that there be consistent rules in the market and that orders of any size and dollar amount be required to interact with one another. Moreover, requiring displayed orders to be executed in accordance with price/time priority would not interfere with the ability of investors to have a traditional broker-dealer "work" an order or to utilize a reserve size feature, if available, to diminish the market impact of a large order.

Transparency and Market Data Fees. Finally, and perhaps obviously, an intermarket price/time priority system would require the adoption first of the short-term recommendations set forth above. In particular, display of a significant depth of orders is necessary to such a

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[14] We believe that the Commission has sufficient authority to adopt such standards. The Concept Release notes that Securities Exchange Act Sections 6, 15A, and 19 provide substantial authority to assure that the rules of the self-regulatory organizations further the national market system.

[15] In general, the Institute supports greater disclosure by market centers and brokers concerning their trade executions and order routing. For this reason, we believe that the disclosure approach set forth as the first option in the Concept Release should be incorporated into any changes adopted by the Commission. We do not believe, however, that disclosure alone would be sufficient. Although such increased disclosures may enable investors to make more informed judgments concerning the quality of executions provided by their brokers, this option alone would not address how to facilitate the interaction of those orders with other orders in the market.

[16] The NYSE objects to a reserve size feature on grounds that it "reduces transparency." *See* Market Structure Report of the New York Stock Exchange, Special Committee on Market Structure, Governance, and Ownership (April 2000). The Institute disagrees. A reserve size function simply provides an automated means for managing displayed orders. Orders in reserve are displayed, and become transparent, as displayed orders at that price are executed against.

system.[17] In addition, such display will only be meaningful if market centers are not permitted to charge inappropriately high fees for accessing these orders. Consequently, the Commission must ensure that there are appropriate safeguards in place to prevent dominant market centers from charging fees that are *de facto* barriers to transparency. One way to address this concern, which the Institute supported in its comment letter on the Commission's concept release regarding market data fees, is to tie fees for accessing orders to some type of flexible cost-based standard.[18]

The Institute believes that once the conditions and standards discussed above can be developed and implemented, the Commission can and should expeditiously move towards the adoption of an intermarket price/time priority system, as contemplated in the sixth option. Such a system would serve the interests of all investors and greatly improve the functioning of our markets.

2. Concerns Raised Regarding Price/Time Priority

Several objections have been raised to a system mandating price/time priority. We believe that these objections either can be addressed or do not withstand scrutiny. For example, arguments have been put forth that a price/time priority system removes incentives for intermarket competition on factors other than price. We believe, however, that there will still be a variety of ways in which markets can, and will, seek to distinguish themselves from other market centers within the broad framework of a price/time priority system, *e.g.*, through reliability, anonymity, reserve book features, and cost of execution. Market centers will have to compete through these services or risk losing order flow to more efficient, less costly market centers.

Nevertheless, even if there is some diminution of competition between markets, this does not mean that the investing public still would not benefit from price/time priority. Seeking to preserve competition among "markets," which are simply aggregations of buyers and sellers, should not become a means to *inhibit* competition *among buyers and sellers*. However, allowing one market to trade ahead of an order placed on another market does exactly this – it *discourages* price competition.

The Institute recognizes that the proliferation of ECNs, and the competition they have fostered, has already led to many enhancements in the securities markets over the last several years. Some market participants conclude from this that we should rely solely on competitive forces to shape the future market environment without any Commission involvement. Yet the features of ECNs that have proven popular and successful, such as displayed limit orders and

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[17] The Concept Release recognizes the importance of transparency, stating that "Price transparency is a minimum essential component of a unified national market system." Concept Release, at n.41 and accompanying text.

[18] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 24, 2000 (File No. S7-28-99) (Regulation of Market Information Fees and Revenues).

price/time priority, are the same features that the Commission should mandate in a new market structure. In addition, many of the benefits of today's "competition" between markets are overstated. For example, we do not believe that regional exchanges have, for the most part, provided meaningful competition to the NYSE.

Finally, many market participants contend that price/time priority will be illusory in a decimal environment because even if an investor places a price setting limit order in one market, a participant in another market could simply provide for price improvement by a *de minimis* amount and obtain priority over that investor's order while risking, in many cases, no more than an additional penny. The Institute disagrees with this argument. Even small price improvements can benefit investors. In addition, while, in today's market environment, a market participant can "step ahead" of a displayed order at no risk, "penny jumping" would at least subject these participants to price risk equal to the magnitude of the price improvement.[19]

III. Conclusion

The structure of the securities markets has a significant impact upon the ability of the Institute's members to serve their millions of shareholders. Chairman Levitt summarized this best when he stated that "when a portfolio manager goes into the market to buy or sell a stock, he or she is often acting not on behalf of the well-heeled private banking client, but on behalf of middle America."[20] We thus strongly support the Commission's initiatives to improve the structure of our markets.

At the same time, we fully expect that there will be strong opposition from many market participants to any meaningful reforms in this area. Many will argue that these reforms will have overwhelmingly adverse effects on the market. We do not believe these fears are well-founded. The changes we are favoring are entirely consistent with those contemplated by Congress in the 1975 amendments to the Securities Exchange Act, which directed the Commission to use its authority under that Act to facilitate the establishment of a national market system and to provide investors with the fairest and most efficient markets possible. Moreover, the same objections have been raised against past reforms proposed by the Commission. For example, many argued that the Order Handling Rules would weaken competition between different types of market centers. As we have seen, these rules have had the opposite effect and have resulted in greater price transparency and tighter spreads. We hope, and thoroughly expect, that the Commission will take the opportunity afforded to it by

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[19] Others have objected to intermarket price/time priority on the grounds that it would require the establishment of a centralized utility to operate the system. As discussed above, the Institute does not believe such a structure would be needed, and would have concerns with any approach that required one.

[20] *See* "Visible Prices, Accessible Markets, Order Interaction," Speech by Securities and Exchange Commission Chairman Arthur Levitt (March 16, 2000).

the Concept Release to address the shortcomings in the markets today and fulfill the responsibility imposed on it by Congress in the Securities Exchange Act.

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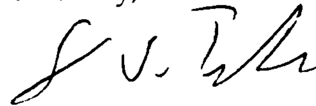
The Institute appreciates the opportunity to comment on the Concept Release. Any questions regarding our comments may be directed to the undersigned at 202-326-5815 or to Ari Burstein at 202-371-5408.

Sincerely,



Craig S. Tyle
General Counsel

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

Annette L. Nazareth, Director
Robert L. D. Colby, Deputy Director
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Securities and Exchange Commission